

# FREDDIE MAC'S ACCOUNTING RESTATEMENT: ARE ACCOUNTING STANDARDS WORKING?

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## HEARING BEFORE THE SUBCOMMITTEE ON COMMERCE, TRADE, AND CONSUMER PROTECTION OF THE COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTH CONGRESS

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## **FREDDIE MAC'S ACCOUNTING RESTATEMENT: ARE ACCOUNTING STANDARDS WORKING?**

**MONDAY, JANUARY 28, 2004**

HOUSE OF REPRESENTATIVES  
COMMITTEE ON ENERGY AND COMMERCE,  
SUBCOMMITTEE ON COMMERCE, TRADE,  
AND CONSUMER PROTECTION,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Shimkus, Shadegg, Ferguson, Issa, Otter, Schakowsky, Solis, Markey, McCarthy, and Strickland.

Staff present: Brian McCullough, majority counsel; David Cavicke, majority counsel; Arturo Silva, deputy communications director; William Carty, legislative clerk; and Consuela Washington, minority counsel.

Mr. STEARNS. Good morning. The subcommittee will come to order.

My colleagues, this is the third hearing we have held in the subcommittee on accounting issues raised by Freddie Mac. The hearing today will focus on two reports: the supplemental report to the Board of Directors of Freddie Mac known as the supplement to the Doty report and submitted to the Board on November 18, 2003; and the report of the special examination of Freddie Mac by the Office of Federal Housing Enterprise Oversight, OFHEO, completed in December 2003.

We have two witnesses here today and I'd like to thank them for appearing before the committee to help us better understand what happened at Freddie Mac.

I would like to thank Armando Falcon, Director of OFHEO, Freddie's regulator for OFHEO's work on parsing through the problems at Freddie that led to Freddie Mac's disregard of financial accounting standards.

I would also like to thank Martin Baumann, CFO of Freddie Mac for being here today.

At the last hearing, we held on the accounting standards issued raised by the Doty report, I complimented Mr. Doty on his thoroughness and objectivity with regard to the internal investigation and the report. Although Mr. Doty is not appearing as witness here today, I wish to acknowledge the supplemental report was produced with the same rigor as the initial report. It also will be a useful tool as guiding our review of accounting standards.

We'll focus on three things today. First, the supplement to the Doty report; second, the OFHEO report; and finally, on the implications of the contents of these reports for fair disclosure under U.S. GAAP.

The supplement to the Doty report addresses issues that were known to require further inquiry at the time of release for the initial report. As with the transactions scrutinized in the final report, hiding income was a primary factor, if not the sole motivation for several transactions investigated for the follow-up report.

The supplement reveals further evidence of earnings management at Freddie Mac. The OFHEO report provides an overview of the culture at Freddie Mac that facilitated earnings management over 11 quarters. The report indicates that Freddie disregarded accounting rules, internal controls, and disclosure standards to maintain a reputation for steady earnings.

So I look forward to hearing from Mr. Baumann about what controls Freddie is putting into place to guard against improper accounting.

The third issue we need to look at today is what this information means for accounting standards. Although Freddie Mac may have made accounting misstatements, it is possible that if some of the transactions were structured more carefully they would have been GAAP compliant. It is possible Freddie could have hidden billions of dollars of income in a way that complied with GAAP.

I suggest this is not the result we want from our United States accounting standards. So called "mixed attribute" accounting allows companies to decide whether financial assets are carried at current market price or at historic costs. Let me repeat. Allows companies to decide whether financial assets are carried at current market price or at historic costs. Freddie Mac shifted assets between categories to manipulate earnings without any change in the underlying economics of its performance.

Now taxpayers do not have the option of changing the characterization of assets to change the tax treatment. I think GAAP should not allow this either. U.S. GAAP was once hailed as a premiere accounting system. I believe GAAP is still a strong accounting system and I applaud FASB for all their efforts to shore up the system over the last 2 years.

While I do not believe Congress is the appropriate body to set detailed accounting standards, I believe we as a committee of oversight over accounting standards setting have a responsibility to ensure standards produce financial statements that are transparent and comprehensible.

I encourage my colleagues to join me to produce legislation to reform GAAP.

I look forward to a dialog here today that will further these efforts and I thank you.

I ask the distinguished Ranking Member for her opening statement.

Ms. SCHAKOWSKY. Thank you, Chairman Stearns, for convening this important hearing to follow up on the accounting scandal at Freddie Mac. I appreciate, Mr. Falcon, and accompanied by Ms. DeLeo this morning and Mr. Baumann's attendance today so that we can go over the Office of Federal Housing Enterprise oversight

examination of just what went wrong at Freddie Mac and Freddie Mac's actual restatement of earnings.

According to OFHEO's report, Freddie Mac used a variety of accounting tricks to move gains and losses around to smooth out and meet earning expectations. Through their manipulations, steady Freddie seemed to live up to its name. However, as its restatement shows, and we all know, the cumulative effect of their attempts was the hiding of \$5 billion of volatility.

Some have been lulled into a sort of complacency with the accounting scandal at Freddie Mac because they under reported their earnings. It seemed that while their true earnings revealed some unsteadiness, what they were hiding was not so bad. They hid profits. But this reporting has been misleading as well. In 2001, Freddie's restatement reveals that they over reported their earnings by \$989 million. Earnings for 2001 actually were about \$1 billion less than they reported. Again, that \$5 billion was accumulative effect of their restatement.

My concerns today are not just with Freddie Mac but also with the agency put in charge of their oversight. OFHEO's oversight was created in 1992 to ensure the safe and sound operations of Freddie Mac and Fannie Mae. However, as OFHEO's report reveals, a lot was happening at Freddie Mac under their oversight.

Today, we'll focus on the accounting issues that were raised by Freddie Mac. Our subcommittee has the responsibility to ensure that all companies provide clear and accurate financial information to the public. The scandal at Freddie Mac is a clear example of what can happen when corporate officers do not abide by the rules of clear and accurate accounting.

All publicly traded companies need to have clear and accurate books. This is especially true for Freddie Mac. What happens at Freddie Mac has a major impact on the housing markets. Freddie purchased almost \$600 billion in mortgages in 2002. It also has helped finance homes for nearly 2.5 million low and moderate income families and families living in under served areas. It was able to do so at least in part because of the benefits and freedoms enjoyed in an established mission as a government-sponsored enterprise.

As we all know, with freedoms come responsibilities. While Freddie was trying to live up to their reputation, they were not living up to their responsibilities. As a GSE and as one of the largest players in the housing market, playing accounting games puts more than the corporation's financial standing at risk. It puts taxpayers and people's homes in jeopardy.

As I said before, Freddie Mac is not just another company. Therefore, we need to make sure that Freddie Mac is as transparent as possible and while I applaud the work that OFHEO has done since the scandal has come to light, and appreciate Freddie's restatement of earnings, willingness to take steps toward remediation, we still have a long way to go.

Freddie Mac needs to be registered with the SEC and voluntary registration is taking too long and does not have the same power as mandated. And that is why I support my colleagues' efforts, Congressmen Shays and Markey, to require Freddie Mac to abide by the same rules of transparency available. Because of who you

are and place you have in making money available for home ownership, it is vital that Freddie Mac is held to at least the same standards as other publicly traded companies, if not higher.

I thank you, Mr. Chairman.

Mr. STEARNS. I thank my colleague. Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. It's an important hearing and it's good to be back and addressing these concerns. I will be brief.

In the committee summary, obviously we're here to review Freddie Mac's announced restated financial cumulative net income increase by \$5 billion regulatory per capita increase by \$5.2 billion; stockholders equity increased by \$6.7 billion. These are obviously restated numbers.

In OFHEO's report under the executive summary, it talks about the corporate culture fostered by the tone at the top resulting in intense and sometimes improper efforts by the enterprise to manage its reported earnings. And in another article in The New York Times dated 30 November, the headline "Hiding Profits is Just Deceitful."

We're even more involved because this is a government-sponsored enterprise. There is connection to us because of that privilege and I think the public is just getting tired of whether it's a for-profit entity or a government-sponsored entity of leadership at the top rigging the books for purposes that are as The New York Times says is deceitful. And so you're here to help us sort through really the blow by blow of where we're at. Then we do need to look with my colleagues in how bills should be written and drafted, laws should be passed to bring some more accountability. The public is just tired and we should not claim and go after one sector of the corporate world while another one goes unscathed for what we would define as improper activity.

So Mr. Chairman, I think it's an important hearing. Thanks for calling it and I yield back the balance of my time.

[The prepared statement of Hon. John Shimkus follows:]

PREPARED STATEMENT OF HON. JOHN SHIMKUS, A REPRESENTATIVE IN CONGRESS  
FROM THE STATE OF ILLINOIS

Good Morning. Mr. Chairman, thank you for holding this hearing to provide a forum for Freddie Mac to restate their financial reports.

This hearing marks the third time in the last 7 months that this Subcommittee has investigated the accounting practices of Freddie Mac. I should hope that this hearing will finally produce an answer to what we have been looking for—the accurate depiction of Freddie Mac's suspicious transactions. The fact that Freddie Mac, a government sponsored enterprise, had to make major revisions to the past three years accounting records only adds fuel to the flame in this era of corporate distrust. And even these records may not be correct, as Freddie Mac will not be issuing its 2002 annual report until June of 2004—over a year later than normal.

I am interested to hear from our panel of witnesses and learn more about the measures that have taken place to correct the improper reporting by this enterprise. I'm also anxious to hear how Freddie Mac plans to avoid this type of situation in the future and comply with the basic accounting standards they have discarded in the past.

Thank you Mr. Chairman, and I yield back the remainder of my time.

Mr. STEARNS. I thank my colleague. The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman, and thank you so much for having this hearing. It is very timely, very important because



Congress did establish Freddie and its sister company, Fannie Mae, to link Wall Street financing to the goal of promoting home ownership throughout Main Street America. In order to advance this objective, Congress has allowed these two companies many regulatory benefits, such as exemption from State taxes, a line of credit at the United States Treasury, an exemption from the registration, financial reporting requirements of the Federal securities laws.

But while Freddie and Fannie might be “government-sponsored enterprises,” they are also private investor-owned corporations. As such, they have responsibilities to their shareholders, including the responsibility to provide full and complete disclosures regarding their financial and operating condition and to obtain audited financial statements that comply with generally accepted accounting principles.

In other words, both of these institutions do a wonderful job in creating more housing in the United States. No one is going to debate that. But many of those very same families then invest their own money into the shares of those companies thinking that it must be a very good company. The government sponsors it. But it isn't required to provide all the same information that other corporations in America are. The transparency is not there, so that investors can make the right decision. And that's why Christopher Shays and I introduced legislation to provide that accurate disclosure and accounting practices at these companies.

Today, we're going to hear from Freddie Mac's principal regulator, the Office of Federal Housing Enterprise Oversight about the results of its investigation into accounting irregularities at Freddie Mac. OFHEO's December 2003 report on its special examination of Freddie Mac raises a number of very disturbing issues that I look forward to hearing about today.

The OFHEO report describes a corporate culture that “casts aside accounting rules, internal controls, disclosure standards and the public trust in the pursuit of steady earnings growth.”

It details instances in which Freddie Mac “knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions” and it finds “a disdain for appropriate disclosure standards” that misled investors, ordinary Americans, putting their money into these companies and undermined market awareness of the true financial condition of the enterprise.

In my view, these findings only serve to underscore the failure of voluntary disclosure to serve the needs of American investors and of our financial markets. In the aftermath of this accounting scandal, it is time for Freddie Mac's new leadership to change course and embrace legislation through repeal of its special exemption from the Securities and Exchange Commission registration and reporting requirements.

There is no single step that Freddie Mac could take that would do more to signal to investors that the corporate culture at the company has changed. There is no single step that the Congress could undertake which would better protect investors from a repetition of the type of accounting problems that we have seen at Freddie Mac.

Mr. Chairman, again, I want to thank you so much for having this very important hearing.

Mr. STEARNS. I thank my colleague. The gentleman from Idaho.

Mr. OTTER. I have nothing.

Mr. STEARNS. Mr. Shadegg, I'm sorry, the gentleman from Arizona.

Mr. SHADEGG. Thank you very much, Mr. Chairman, for holding this hearing. Since our last hearing on this issue on September 25, the restatement by Freddie Mac of its 2002 financial information, coupled with the release of the reports by Baker Botts and OFHEO weren't another look at the accounting problems which beset Freddie Mac.

I am pleased that we have such knowledgeable witnesses present and was interested to read in their testimony not only the description of what went wrong, but also the steps that Freddie Mac can and in some instances is taking to correct the situation which gave rise to the accounting problems.

I am also encouraged that Freddie Mac has appointed a chief compliance officer to ensure that at least one key employee in the company has legal and regulatory compliance as his primary function. Important as such structural improvements are, however, they pale in comparison to the need to instill in all employees, managers and board members, the understanding that accounting standards are not a performance metric to be manipulated or worked around, but rather a gauge which must be kept accurate.

At the hearing last September, I made the point that accurate accounting could best be encouraged through the establishment of guidelines, rather than overly formulaic rules which can be avoided on technicalities. I'm building a home right now and there are certain building codes which it must comply with. Obviously, it's important to comply with those codes, but it's more important that the home actually be well constructed and that it will last for decades and so complying with the code isn't the issue, building a sound home is, in fact, the issue.

I was interested to see that in the testimony of Mr. Falcon, he bolstered my position. He notes that "to maintain Freddie Mac's image as a smooth and steady earning machine, it is now clear that management went to extraordinary lengths to transact around FAS 133 and at times failed to comply with GAAP." He also discusses the culture of deception which existed among some members of Freddie Mac's management team and their willingness to disguise earnings.

In the next few weeks we will consider legislation to institute certain reforms to Freddie Mac and other government-sponsored enterprises. It is my hope that this legislation will be structured to not only ensure greater compliance with technical accounting standards, but will result in greater attention to the spirit of accurate reporting without which the standards themselves are meaningless.

I thank you, Mr. Chairman, again for this hearing and look forward to the testimony of our witnesses.

Mr. STEARNS. I thank the gentleman. Good morning, Ms. Solis, you're welcome. You can take your time and we welcome your opening statement if you have one?

Ms. SOLIS. I'd like to submit my statement for the record, thank you.

Mr. STEARNS. By unanimous consent, so ordered.

[The prepared statement of Hon. Hilda L. Solis follows:

PREPARED STATEMENT OF HON. HILDA L. SOLIS, A REPRESENTATIVE IN CONGRESS  
FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman, for calling this hearing today. I'm pleased that this Subcommittee is continuing to examine the problems uncovered at Freddie Mac last year, as well as the state of accounting standards in general.

I share the concern held by many of my colleagues on this panel about the lack of transparency in corporate accounting. I believe it is critical that companies provide thorough and accurate information about their financial status to the public. We should not leave investors in the dark, defenseless against sloppy accounting by corporate managers.

Holding corporations accountable is especially important for government-sponsored entities such as Freddie Mac. We all know that Freddie Mac, along with Fannie Mae, is crucial to the housing market. This is especially true in districts such as mine in Los Angeles County, which is home to many low to moderate income families, the majority of whom are Latino and Asian. I hope that as we continue to evaluate this issue, we will keep these consumers—and all taxpayers—in mind.

It is in the best interest of our constituents to have a viable, secondary housing market. Improving transparency and disclosure requirements will help accomplish this goal.

I want to thank the witnesses for joining us today. I look forward to their testimony.

Thank you.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON  
ENERGY AND COMMERCE

This is the third hearing Chairman Stearns has held on accounting problems at Freddie Mac. I commend Chairman Stearns for his dogged pursuit of the technical issues associated with accounting questions.

The most important lesson we have learned from this inquiry is that GAAP Accounting Standards as set by FASB leave much to be desired. Although Freddie Mac violated GAAP by hiding billions of dollars in earnings, had they done their accounting more carefully, some of those transactions would have been permissible.

So called "mixed-attribute accounting" allows some financial firms to vary the accounting treatment of an asset by characterizing the asset as "available for sale" or "held for investment". By manipulating these categories, some financial firms can alter their accounting by billions of dollars without any regard to economic reality. This anomaly should change. FASB should be encouraged to adopt a rule correcting this.

We know from the corporate scandals that have surfaced in the past two years that it is difficult to regulate fraud. However, lost in some of the particular cases is why no one discovered the truth earlier. Are accounting standards so complex that virtually anything can be hidden or are they so complex that no one is smart enough to understand the financial statements? Simply stating that accounting standards should be simpler sounds great, but will it benefit anyone if the information is meaningless?

I commend Chairman Stearns for his attention to these questions and hope that the Subcommittee will continue this inquiry in this Congress.

Mr. STEARNS. Mr. Falcon, I think we're taken care of all our opening statements, so we welcome you this morning, for your opening statement.

**STATEMENT OF HON. ARMANDO FALCON, JR., DIRECTOR,  
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**

Mr. FALCON. Thank you, Mr. Chairman, Ranking Member Schakowsky, I apologize for the error in my written testimony

about the misnomer, and members of the subcommittee. Let me introduce to my left, Ms. Wanda DeLeo, who is the Chief Accountant at OFHEO. I asked her to join me up here to assist me in answering any detailed questions about accounting matters at Freddie Mac.

I appreciate the opportunity to discuss with you OFHEO's report of the special examination of Freddie Mac. My written testimony discusses the key findings and conclusions of the report, focusing largely on accounting and earnings management issues. I request that the committee include it, as well as the full text of the report in the record.

Mr. STEARNS. By unanimous consent, so ordered.

Mr. FALCON. Thank you. A year ago, Freddie Mac announced that completion of its 2002 financial audit would be delayed and that earlier periods would be re-audited and restated. They switched external auditors from Arthur Anderson to PriceWaterhouseCoopers. That triggered an assessment of Freddie Mac's accounting policies and practices.

On June 7, as this re-audit was underway, Freddie Mac announced the abrupt departure of three of its principal officers. At the same time, I ordered a special examination of the circumstances that led to the restatement and management changes.

Although some aspects of the special examination are not yet complete, the bulk of the work was finished this past fall. OFHEO issued a report of the examination containing the findings and conclusions along with appropriate recommendations in December.

Let me now turn to the major findings of the special examination. The report of the special examination of Freddie Mac reveals how Freddie Mac manipulated its reported earnings and disclosed other financial information in a misleading way in 1999 through 2002. The report provides a chronology of relevant events, reviews the strategies that Freddie Mac employed to manipulate earnings and indicates that the Board was made aware of transactions whose sole purpose was to shift income.

The report also shows how the executive compensation program of Freddie Mac, particularly the compensation tied to earnings per share, influenced accounting and management practices during that period.

On January 1, 2001, Freddie Mac, along with other financial institutions, was required to implement FAS 133, "Accounting for Derivative Instruments and Hedging Activities." In addition to their many operational challenges, FAS 133 was problematic to Freddie Mac with respect to its goal of steady earnings growth. Specifically, FAS 133 required management to record a transition adjustment based upon any embedded gain or loss in its derivatives portfolio upon adoption of the standard.

Freddie Mac's derivatives portfolio, in particular, its portfolio of interest-rate swaptions, had substantial gains that had to be recognized on the transition date. Management sought to minimize this transition adjustment, in part to minimize the appearance of volatility on its balance sheet, as well as to shift derivative gains into future periods and recognize them gradually into income.

To maintain Freddie Mac's image as a smooth and steady earnings machine, never perturbed by changes in interest rates, mort-

gage volumes, or other economic factors, it is now clear that management went to extraordinary lengths to transact around FAS 133, and at times failed to comply with GAAP. One example of this was the “Coupon Trade-Up Giant” transaction, referred to in our report as a “CTUG.”

The purpose of the CTUG transaction was to move securities with embedded losses from the held-to-maturity portfolio to the trading portfolio and then into the available for sale portfolio. Management wanted the benefit of having its securities in a trading account but only for enough time to realize a loss and offset its derivative gains.

The CTUG transaction was a transaction with little or no economic substance that Freddie Mac manufactured in order to obtain a particular accounting result. Indeed, the economic aspects of the deal were negative when one considers the operational hazards created by the transaction which compounded Freddie Mac’s accounting and control weaknesses.

The report of special examination also detailed the use of a dubious method by Freddie Mac to value its swaptions portfolio in a way that minimized its derivatives gain. The report describes how the head of Freddie Mac’s Market Risk Oversight unit worked with Freddie Mac’s derivatives desk to reverse-engineer a lower value for its swaptions portfolio. The revised swaption valuation method contributed to a \$730 million misstatement of the 2001 financial results of Freddie Mac.

This is illustrative of the culture at Freddie Mac at that time and highlights the willingness of all levels of management to disguise earnings.

The FAS 133 transition was not the only episode of improper earnings management activities. In January 2001, the shape of the yield curve began to change dramatically in favor of Freddie Mac which resulted in the windfall of net interest income for the enterprise. In order to shift some of this windfall from 2001 into the future, management executed the first of several interest rate swap transactions that were referred to in the report as linked swaps. Each pair of swaps substantially offset each other and was virtually riskless for Freddie Mac and their counterparts. The link swaps moved approximately \$450 million in operating earnings from 2001 into future years.

The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share also contributed to the improper accounting and management practices of the enterprise. The size of the bonus pool for senior executives was linked, in part, to meeting or exceeding annual specified earnings per share targets. While not tied directly to smoothing earnings growth, actions shifting earnings from one quarter to future periods helped ensure that earnings per share goals and consequently the bonuses based upon them would be achieved in the future.

In some instances, Freddie Mac knowingly circumvented prevailing public disclosure standards in order to conceal particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and un-

dermined market awareness of the true financial condition of the enterprise.

Within Freddie Mac, no one took responsibility for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such a lack of assigned responsibility reflected the low regard executive management held for that function.

For the most part, the same long-tenured shareholder-elected directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The non-executive directors became complacent and allowed past performance of those officers to color their oversight. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected directors or if directors had not expected to continue to serve on the board until the mandatory retirement age or beyond.

The management of a corporation is responsible for maintaining a control environment that will, among other things, accurately record transactions to provide for published financial statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth in earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing, skills and resources in the Corporate Accounting Department of the enterprise led to weak or nonexistent accounting policies, an over reliance on the external auditor, weak accounting controls and an over reliance on manual systems.

A thorough review and update of accounting policies had not occurred in over 12 years. Freddie Mac's accounting errors during this time period were pervasive and persistent occurring in more than 30 different accounting issue groups. The weaknesses in accounting policies created an environment that allowed for and even encouraged transacting around GAAP. These weaknesses also encouraged an over reliance on Arthur Andersen, the external auditor. Arthur Andersen was soon in a position of auditing its own work.

Freddie Mac, as part of the restatement process has reviewed over 150 accounting policies. Senior management and the board did not establish and retain a strong internal control system. Therefore, they could not provide reasonable assurance that transactions were recorded as necessary to permit preparation of the financial statements in accordance with GAAP. As a direct result of management and the board not addressing these weaknesses in a timely fashion, Freddie Mac went 10 months without audited financial statements for 2002; was forced to re-audit and restate both 2000 and 2001 financial statements and will not be able to provide investors with quarterly information until at least mid-2004.

An internal audit report dated December 1996 reported that controls over the derivatives execution, administration, and accounting processes require improvement and that further deterioration in controls could affect the reliability of financial reporting. Neither management, internal audit or the external auditor addressed these weaknesses during the next 7 years.

It should be noted that inadequate documentation and controls surrounding the accounting for derivatives were identified as one of the six major restatement issues and constitute the largest dollar impact of the restatement. Many of the weaknesses discussed to date were identified by the internal audit, but remained outstanding for a number of years.

In evaluating the role of the internal audit department, the investigation revealed that internal audit did not fully comply with industry standards or best practices in the areas of competency and communication with the board and management. By not following up quickly enough or failing to report the failure of management to remedy major control weaknesses during that period of the restatement, the internal audit function increased the exposure of Freddie Mac to risk.

Based upon these findings, the examination report recommended that OFHEO and Freddie Mac take a broad range of actions. As a general matter, the report concluded that OFHEO must ensure that Freddie Mac establish an adequate remediation plan and is allocating the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility, and that penalizes the failure to meet appropriate standards of conduct.

There is a full discussion of these specific recommendations in my written testimony. OFHEO's report contains 16 recommendations that I have adopted and am moving forward to implement. I am pleased to inform the subcommittee that the majority of these actions have been put in place.

Of the 14 recommendations relating directly to Freddie Mac, a consent order has applied 11 of these recommendations. I am now moving within OFHEO on the remaining three. The consent order entered into on December 9th with Freddie Mac expands on the recommendations of the report.

The Board of Directors is reviewing the company's bylaws, codes of conduct and employee training to ensure that changes are made to avoid problems that were discovered in the course of the investigation. The Board will review and recommend changes to its committee structure to meet its oversight obligations including risk and internal controls that were issues in the accounting area.

The Board and senior management must be briefed not less than annually under legal and regulatory responsibilities, including a meeting with OFHEO personnel.

Freddie Mac is developing with OFHEO oversight, a program to revise its management culture to give equal weight to compliance and operational stability alongside other corporate goals. This includes executive compensation that contributed to the accounting failures.

The enterprise will have a consultant review its accounting and financial reporting changes and communicate to OFHEO on this and improvements to internal controls. The enterprise must act to improve its internal audit function and internal accounting.

As to specific unique transactions that did not have a business purpose, the enterprise will assure that a valid business purpose exists for transactions and that they are documented under GAAP.

Finally, the Board must report quarterly on progress in meeting the requirements of the consent order and our staff and Freddie Mac's management, I can assure, are meeting on a much more frequent basis than that.

Overall, I believe that Freddie Mac has been subject to a rigorous corrective plan by OFHEO and one that establishes accounting as a central point of concern. Freddie Mac has engaged with OFHEO actively and has been operating in a manner that is satisfactory to OFHEO in working through these remedial steps.

Mr. Chairman, that concludes my prepared remarks and I am pleased to answer any questions that you or other members of the subcommittee may have.

[The prepared statement of Hon. Armando Falcon, Jr. follows:]

PREPARED STATEMENT OF HON. ARMANDO FALCON, JR., DIRECTOR, OFHEO

Mr. Chairman, Ranking Member Schakowsky, and Members of the Subcommittee, I appreciate the opportunity to discuss with you OFHEO's Report of the Special Examination of Freddie Mac. My prepared testimony will summarize the key findings and conclusions of the report, focusing largely on the accounting issues, and I request that the Committee include it as well as the full text of the report in the record. My testimony expresses my own views and not necessarily those of the President or the Secretary of Housing and Urban Development.

Mr. Chairman, OFHEO is an independent agency, chartered by Congress in 1992 and funded by assessments on the government sponsored enterprises it supervises, Fannie Mae and Freddie Mac. OFHEO's mission is to ensure the safe and sound operation of the Enterprises. As do other safety and soundness regulators, OFHEO employs a full range of supervisory and enforcement tools including examinations, capital standards, and prompt corrective action procedures.

A year ago, Freddie Mac announced that completion of its 2002 financial audit would be delayed and that earlier periods would be reaudited. A switch in external auditors—from Arthur Andersen to PricewaterhouseCoopers—had triggered a reevaluation of Freddie Mac's accounting policies, especially those relating to hedge accounting treatments for derivatives occasioned by implementation of FAS 133. However, the reaudit and restatement process itself raised questions beyond merely the choice of accounting policies.

On June 7, as Freddie Mac prepared to announce the abrupt departure of three of its principal officers, I ordered a special examination of the conditions and activities that led to the accounting failures and management changes.

Although some aspects of the special examination are not yet complete, the bulk of the work was finished this past fall. OFHEO issued a report of the examination containing the findings and conclusions, along with appropriate recommendations, in December.

Since the early 1990s Freddie Mac promoted itself to investors as "Steady Freddie," a company of strong and steady growth in profits, and developed a corporate culture that placed a very high priority on achieving such results. The special examination showed that, to do so, Freddie Mac used means that failed to meet its obligations to investors, regulators and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth. The conduct and intentions of the Enterprise were hidden and were revealed only by a chain of events that began when Freddie Mac changed auditors in 2002.

IMPROPER MANAGEMENT OF EARNINGS

The Report of the Special Examination of Freddie Mac reveals how Freddie Mac manipulated its reported earnings and disclosed other financial information in a misleading way in 1999 through 2002. The Report provides a chronology of relevant events, reviews the strategies that Freddie Mac employed to manipulate earnings, and indicates that the Board was made aware of transactions whose sole purpose was to shift income. The Report also shows how the executive compensation program of Freddie Mac, particularly compensation tied to earnings per share, influenced accounting and management practices during that period.



In the period covered by the special examination, senior management at Freddie Mac placed an inordinate emphasis on achieving steady, stable growth in earnings per share.

Freddie Mac adopted the goal of steady earnings growth in the early 1990s after some investors told management that the Enterprise needed to communicate clear and simple messages that the public could easily understand. Fifteen to sixteen percent earnings growth, or “mid-teens earnings growth,” was the simple message that management began to communicate. That goal was fairly easy when Freddie Mac was primarily a securitizer of mortgages. However, as the retained mortgage portfolio of the Enterprise grew and its earnings became more sensitive to interest rates, steady mid-teens growth became a more challenging goal.

On January 1, 2001, Freddie Mac, along with other financial institutions, was required to implement FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Given the large size of Freddie Mac’s derivatives portfolio, FAS 133 presented management with many operational challenges relating to systems, documentation, and accounting infrastructure. However, in addition to the operational challenges, FAS 133 was problematic to Freddie Mac with respect to steady earnings. Specifically, FAS 133 required management to record a transition adjustment based upon any embedded gain or loss in its derivatives portfolio upon adoption of the standard. Freddie Mac’s derivatives portfolio, in particular its portfolio of interest-rate swaptions, had substantial gains that had to be recognized on the transition date. Management sought to minimize this transition adjustment, in part to minimize the appearance of volatility on its balance sheet, as well as to shift derivative gains into future periods and recognize them gradually into income.

To maintain Freddie Mac’s image as a smooth and steady earnings machine, never perturbed by changes in interest rates, mortgage volumes, or other economic factors, it is now clear that management went to extraordinary lengths to transact around FAS 133, and at times failed to comply with GAAP. One example of this was the “Coupon Trade-Up Giant” transaction, referred to in the Report as “CTUG.” The purpose of the CTUG transaction was to move securities with embedded losses from the held-to-maturity portfolio (where losses are unrecognized) to the trading portfolio (where losses would be immediately recognized in net income and would offset derivative gains), and then into available-for-sale portfolio (where securities gains and losses only hit “other comprehensive income,” not “net income”). The last step was accomplished with the help of Salomon Smith Barney Holdings, which is now part of Citigroup, and involved combining \$30 billion in mortgage-backed securities into four “Giant” securities. Management wanted the benefit of having its securities in a trading account but only for enough time to realize a loss and offset its derivative gains.

However, the transfer to the available-for-sale portfolio was unwound during Freddie Mac’s re-audit in 2003. In addition to numerous operational problems caused by trying to move \$30 billion in mortgage-backed securities in a short period of time, and the fact that Salomon Smith Barney only took possession of the securities for a few hours before shipping them back to Freddie Mac, a reaudit ultimately concluded that the classification from Trading to Available-for-Sale should not have been permitted. Transfers into or from the trading category should be rare, and “rare” is generally interpreted to mean “never” both in practice and by the SEC. The first transfer to trading was permissible under FAS 133 transition values, but not the second transfer. That transfer would have required substantive trades. However, Freddie Mac did not obtain a legal true sale opinion on these transactions. CTUG was a transaction with little or no economic substance that Freddie Mac manufactured to obtain a particular accounting result. Indeed, the economic aspects of the deal were negative when one considers the operational hazards created by the transaction, which compounded Freddie Mac’s accounting and control weaknesses.

The Report of Special Examination also detailed the use of a dubious method used by Freddie Mac to value its swaption portfolio in order to minimize its derivatives gain at the time of the FAS 133 transition. The Report describes how the head of Freddie Mac Market Risk Oversight unit worked with Freddie Mac’s derivatives desk to reverse-engineer a justification for a lower value for the swaptions portfolio. The revised swaption valuation method contributed to a \$730 million misstatement of the 2001 financial results of Freddie Mac. The fact that the head of Market Risk Oversight worked hand-in-glove with a unit he was responsible for overseeing to craft a dubious valuation methodology is illustrative of the culture at Freddie Mac at that time and highlights the willingness at all levels of management to disguise earnings.

The FAS 133 transition was not the only episode of improper earnings management activities. For example, in January 2001, the shape of the yield curve began to change dramatically in favor of Freddie Mac, as the Federal Reserve began to

lower its target for the Fed funds rate, which resulted in a much steeper yield curve and a windfall of net interest income for the Enterprise. This windfall was made larger by derivative positions put in place at the end of 2000 that benefited from the steeper yield curve. In order to shift some of this windfall from 2001 into the future, management executed the first of several interest-rate swap transactions that are referred to in the Report as the “linked swaps.” The terms of each pair of swaps substantially offset each other and were virtually riskless for Freddie Mac and their counterparties. The swaps also had little effect on GAAP income but the negative cash flow from the first swaps in each pair was reflected in operating earnings, a non-GAAP metric that Freddie Mac highlighted for the investing public. The linked swaps, in aggregate, moved approximately \$450 million in operating earnings from 2001 into later years. Handwritten notes from Freddie Mac’s Board meeting in September 2001 show that management informed the Board that derivatives were being used to shift income.

Other earnings management techniques involved keeping the level of loan loss reserves higher than allowed by GAAP, and maintaining a reserve account to cushion fluctuations in premiums and discounts resulting from mortgage prepayments. That reserve, known at Freddie Mac as the FAS 91 reserve, was not allowed by GAAP, but Freddie Mac’s outside auditor, Arthur Andersen, chose to look past it. When Arthur Andersen began receiving negative publicity in late 2001 and early 2002 for its work with Enron, the Chief Operating Officer of Freddie Mac resisted pressure from the Board to change auditors, since he was aware that hiring new auditors could result in increased “restatement risk.” Ultimately, the Board insisted on hiring new auditors, and his fears of restatement were realized.

#### EXECUTIVE COMPENSATION

The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, also contributed to the improper accounting and management practices of the Enterprise. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. While not tied directly to smoothing earnings growth, actions shifting earnings from one quarter to future periods helped ensure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future.

#### DISCLOSURE

In some instances, Freddie Mac knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the Enterprise.

Within Freddie Mac, no one took responsibility for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such a lack of assigned responsibility reflected the low regard executive management had for that function.

#### BOARD OF DIRECTORS

For the most part, the same long-tenured shareholder-elected Directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The non-executive Directors allowed the past performance of those officers to color their oversight. Directors should have asked more questions, pressed harder for resolution of issues, and not automatically accepted the rationale of management for the length of time needed to address identified weaknesses and problems. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected Directors or if Directors had not expected to continue to serve on the Board until the mandatory retirement age or beyond. Conversely, the service periods of the presidentially appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board.

#### WEAK ACCOUNTING, AUDITING AND INTERNAL CONTROLS

The management of a corporation is responsible for maintaining a control environment that will, among other things, accurately record transactions to provide for published financial statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth in earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing, skills, and resources in the Corporate Account-

ing Department of the Enterprise led to weak or nonexistent accounting policies, an over reliance on the external auditor, weak accounting controls, and an over reliance on manual systems. Given the size of the company and its role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the Enterprise.

#### ACCOUNTING PERSONNEL AND EXPERTISE

The staffing levels and experience in the financial accounting reporting functions were insufficient throughout the restatement periods. The key finance functions over this period were unbalanced with major gaps either left unfilled or filled with interim personnel with inadequate skills. This shortage of staff and experience caused key person dependencies in crucial control areas. The need for skill and experience is heightened when the process is complex, as is the derivatives and securitization accounting process at Freddie Mac. Many of the strategies and transactions during this period were not GAAP compliant; therefore, Freddie Mac was faced with one of the largest restatements in corporate history.

The primary responsibility for an entity's financial statements rests with management. Part of that responsibility is to assure that staffing levels in financial accounting are sufficient to support a control environment within the financial reporting process to ensure that significant errors are either prevented or detected at an early stage. Senior management and the Board failed to provide adequate resources to the corporate accounting function even though they were being continuously told about the weaknesses.

Senior management simply ignored warning signs about problems in Corporate Accounting and/or did not consider the problems important enough to provide adequate supervision, funding and or insist on a timely resolution. The lack of attention to staffing, skill set and resources led to weak or non-existent accounting policies, weak accounting controls, over reliance on manual systems and over reliance on the external auditor. Each of these areas will be discussed in turn.

#### ACCOUNTING POLICIES

A thorough review and update of accounting policies had not occurred at Freddie Mac in over twelve years. Accounting policies should be researched and documented regularly to assure proper accounting treatment of existing and new business transactions. They should be used as a mechanism to keep employees informed of how to account for new and recurring transactions. Many of the transactions and policies that have been investigated at Freddie Mac did not have established accounting policy guidance and/or the policies in place were outdated, insufficient or incorrect, leading to misapplication of GAAP and, ultimately, to the need to reaudit and restate its financial statements.

Freddie Mac's accounting errors during this time period had been pervasive and persistent; occurring in more than 30 different accounting issue groups. The weaknesses in accounting policies created an environment that allowed for and even encouraged transacting around GAAP. These weaknesses also encouraged an over reliance on Arthur Andersen, the external auditor, a situation which led to questions as to auditor independence.

Management used the weak accounting policy group and the non-existent process surrounding the setting of accounting policies to justify accounting practices after transactions had taken place rather than allowing the group to set "best practice". Freddie Mac, as part of the restatement process, has rewritten and/or reviewed 150 accounting policies.

#### OVER RELIANCE ON ARTHUR ANDERSEN

Freddie Mac's shortage of accounting staff, inadequate expertise and weak or non-existent accounting policies led to an environment that encouraged reliance on the external auditors for basic accounting functions and decisions. This dependency led to the external auditor acting in a first-line management capacity, taking part in day-to-day operations, and, to an extent, and auditing its own work.

In 2001, Arthur Andersen received \$1 million for its audit work and \$3.7 million for its consulting fees, of which \$1.5 million related to FAS 133 consulting. OFHEO believes that Arthur Andersen's independence as an auditor may have been compromised by the size of the consulting fees compared to the fees charged for the audit work.

SEC requirements for independence of auditors are clear that in day-to-day operations of the business, external auditors may not function as management or as an employee of its audit client. Arthur Andersen appears to have disregarded this principle by counseling the company on issues ranging from FAS 133 implementation

to accounting affects of new products. The many organizational changes in the accounting department heads, especially at the controller position, led to the accounting staff heavily relying on Arthur Andersen.

In this regard, evidence supports the conclusion that Arthur Andersen was participating in day-to-day decisions and often acting as an employee or in a management capacity. They also performed extensive consulting work that may have led them to use extreme and sometimes unsupportable assumptions to support specific transactions. Couple this with an environment where management often negotiated accounting decisions and in some cases went as far as suggesting a change in auditors if desired results were not achieved, and the result is an environment which can compromise the auditor's independence.

There are also indicators that the Board was comfortable relying completely on the external auditor for accounting expertise. This contradicts current accounting literature, which holds management accountable for the accuracy of their financial statements.

#### ACCOUNTING CONTROLS

Senior management and the Board did not establish and maintain a strong internal control system. Therefore, they could not provide reasonable assurance that transactions were recorded as necessary to permit preparation of financial statements in accordance with GAAP. As a direct result of management and the Board not addressing these weaknesses in a timely fashion, Freddie Mac went ten months without audited financial statements for 2002, was forced to reaudit and restate both 2000 and 2001 financial statements, and will not be able to provide investors with current quarterly information during 2004.

As noted previously, staffing levels and expertise in the financial accounting area have been insufficient since at least 1998. It has also been demonstrated that the enterprise operated from 1991 to 2003 with non-existent or outdated accounting policies and manuals. Add to this insufficient controls over the financial reporting process such as system and data integrity issues in debt and derivatives accounting, account reconciliation issues, an ineffective process to react promptly to new transactions, and a labor intensive close-out process and you have an environment that will not only allow errors but will most likely result in material misstatements in the financial reporting process. Discussed below are some of the weaknesses in controls that existed during the restatement period.

#### DERIVATIVES

In an internal audit report dated December 1996, the General Auditor reported that controls over the derivatives execution, administration, and accounting processes require improvement and that further deterioration in controls could prevent objectives relating to the effectiveness and efficiency of operations and the reliability of financial reporting from being achieved.

Management through their internal self-assessment process also identified these same weaknesses. Weaknesses within the derivative area continued to be identified, but not addressed by management, internal audit, or the external auditor during the next seven years. The latest internal audit report stated that inadequate documentation of hedge effectiveness and other required information could disqualify the use of favorable FAS 133 accounting treatment. The report also stated that procedures for derivatives accounting processes, including documentation, effectiveness testing, quality control, analysis, and management review, need improvement to ensure compliance with hedge accounting standards. Significant functional limitations in the derivatives accounting systems create an elevated risk of material operational error. It should be noted that inadequate documentation and controls surrounding the accounting for derivatives were identified as one of the six major restatement issues and constitute the largest dollar impact of the restatement.

#### RECONCILIATIONS

General ledger account reconciliations are a key internal control necessary/used to provide reasonable assurance that the corporation's financial statements fairly present its financial position and results of operations. Not reconciling general ledger accounts dramatically increases the risk that financial reports will not be accurate. The issue regarding reconciliation was brought to management's attention as early as 1995. At that time Internal Audit reported that corporate accounting was not effectively monitoring account reconciliations performed by the decentralized account unit.

Internal Audit again identified reconciliation weaknesses in their 1998 audit. And in 1998 and 1999 Arthur Andersen addressed the issues regarding reconciliation

and data integrity in its management letters. In fact, in 1998 Arthur Andersen said that guidance should be provided for the timely and consistent reconciliation of data to the general ledger and other approved sources of data. Reconciliation issues were still outstanding in 2002.

#### INTERNAL AUDIT FUNCTION

Many of the weaknesses discussed to date were identified by Internal Audit but remained outstanding for a number of years. In evaluating the role of the Internal Audit Department the investigation revealed that Internal Audit did not fully comply with industry standards or best practices in the areas of competency and communication with the Board and Management.

Best practices do not require internal auditors to conduct financial audits, but the Internal Audit Department of Freddie Mac should have policies and procedures in place to address its obligation to evaluate risk exposure relative to the reliability and integrity of the financial information of the Enterprise. Given the volume and wide range of accounting errors made by Freddie Mac, the conclusion of the Internal Audit Department that financial accounting and reporting controls were marginal was a substantial overstatement of their quality.

Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended. A review of relevant internal audit reports noted several instances where major control weaknesses identified as early as 1998 remain unresolved five years later. In many of these instances, internal audit identified major control weakness and set agreed upon actions as well as target completion dates. However, the completion dates of the corrective actions were repeatedly extended. As a result, each of the issues remained outstanding.

By not following up quickly enough or failing to report the failure of management to remedy major control weakness during the period of the restatement, the internal audit function increased the exposure of Freddie Mac to risk.

The Internal Audit Department of Freddie Mac did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board. In combination, the weaknesses in Corporate Accounting, the Internal Audit Department, and questionable independence of the external auditor meant that there were weak points at each major control juncture at Freddie Mac.

#### CONCLUSION

Weaknesses in the Corporate Accounting area with respect to staffing, skill set, and resources led to weak or non existent accounting policies, an over reliance on the external auditors, weak accounting controls and an over reliance on manual systems. Couple this with a weak internal audit department that did not accept responsibility for the reliability and integrity of financial information, did not maintain effective controls over the review and follow-up of audit findings and you have an environment with weak points at each major control juncture.

This weak control environment provided the opportunity for management to promote an attitude that GAAP was something to be transacted around. In this regard, the attention of management on meeting analyst's expectations at the expense of proper accounting policies and strong accounting controls lead to aggressive accounting and concurrently resulted in the restatement and reaudit. Management and the Board continually ignored their responsibility for adopting sound accounting policies, establishing and maintaining a strong internal control system to assure that financial statements were prepared in accordance with GAAP. The Board appeared to be operating under the misconception that as long as the external accounting firm signed off on a policy or transaction that management's responsibility was fulfilled.

Management and the Board must accept full responsibility for the Company's financial statements. The auditor's responsibility is to express an opinion on the financial statements. It is management's responsibility to adopt sound accounting policies and to establish and maintain an internal control environment that among other things will ensure the effectiveness of the accounting and financial reporting processes. Freddie Mac's Senior Management and Board did not live up to these responsibilities during this timeframe.

#### RECOMMENDATIONS

The examination report recommended that OFHEO and Freddie Mac take a broad range of actions. I agree with the recommendations and we are moving to imple-

ment them. As a general matter, the report concluded that OFHEO must ensure that Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility, and that penalizes failure to meet appropriate standards of conduct.

The report also detailed a number of specific actions. To improve the effectiveness of the Board of Directors, Freddie Mac should separate the functions of the Chief Executive Officer and the Chairman of the Board, impose strict term limits on Directors, and require that the Board meet more frequently.

To address Freddie Mac's general neglect of operations risks and compliance issues, the report recommends that Freddie Mac establish a formal compliance provision and a position of Chief Risk Officer, reporting directly to the CEO, with explicit responsibility for operations risk, as well as credit and market risk. In addition, Freddie Mac's Internal Audit Department needs to be strengthened so that it can play a more effective role.

To address accounting weaknesses, Freddie Mac will review all accounting and financial reporting changes and communicate this to OFHEO. The enterprise must also act to improve its internal audit and accounting functions. The report also recommends that OFHEO consider requiring a periodic change of external audit firms. Freddie Mac needs to establish and maintain superior accounting controls and prevent undue reliance on its external auditor. It must also document the legitimate business purpose of every significant business transaction.

To address inappropriate managerial incentives, the report recommended that Freddie Mac refocus its compensation program more on long-term goals, not on short-term earnings.

Until remediation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. The report recommends that OFHEO consider addressing this concern by requiring Freddie Mac to hold significant regulatory capital surpluses, at least until it can produce timely and GAAP-consistent financial reports.

Finally, the report recommends that OFHEO take three additional steps to reduce the possibility of future Enterprise difficulties. First, OFHEO should implement regulations that provide for mandatory disclosure, similar to that required of SEC-registered companies, if Congress does not repeal the exemptions of the Enterprises from securities law. Second, OFHEO should expand its capacity to detect and investigate misconduct by including more substantive tests of the internal control frameworks at the Enterprises, including procedures to identify pressures to commit fraud and opportunities to carry it out. Third, OFHEO should conduct a special examination of the accounting practices of Fannie Mae.

#### OFHEO ACTIONS

Mr. Chairman, I am pleased to inform the subcommittee that the majority of these actions have been put in place. Of the 14 recommendations relating directly to Freddie Mac, a consent order has applied 11 of these recommendations, while I am moving now within OFHEO on the remaining three.

The consent order entered into on December 9th with Freddie Mac expands on the recommendations of the report and Freddie Mac has initiated a compliance program with the consent order that OFHEO is not only monitoring but working with the management to see that it moves along promptly.

Key provisions for accounting matters and related matters are as follows:

The Board of Directors is reviewing the company's bylaws, code of conduct and employee training to assure that changes are made that will support an environment to avoid problems that were discovered in the course of the investigation. The Board will review and recommend changes to its committee structure to meet its oversight obligations including operations risk and internal controls that were issues in the accounting area. The Board and senior management must be briefed not less than annually on their legal and regulatory responsibilities; this includes no less than annually a meeting with OFHEO personnel.

Freddie Mac is developing, with OFHEO oversight, a program to revise its management culture to give equal weight to compliance and operational stability along side other corporate goals; this includes executive compensation that contributed to the accounting failures.

The Enterprise will have a consultant review its accounting and financial reporting changes and communicate to OFHEO on this and improvements to internal controls. The Enterprise must act to improve its internal audit function and internal accounting.

As to specific unique transactions that did not have a business purpose, the Enterprise will assure that a valid business purpose exists for transactions and that they are documented under GAAP.

Finally, the Board must report quarterly on progress in meeting the requirements of the consent order and our staff and Freddie's management, I can assure you, are meeting on a much more frequent basis than that.

Overall, I believe that Freddie Mac has been subject to a rigorous corrective plan by OFHEO and one that establishes accounting as a central point of concern. Freddie has engaged with OFHEO actively and has been operating in a manner that is satisfactory to OFHEO in working through these remedial steps.

That concludes my prepared remarks. I am pleased to answer any questions that you and Members of the Committee may have.

Mr. STEARNS. Mr. Falcon, thank you very much. Does your associate, Ms. DeLeo, do you have anything that you would like to say?

Ms. DELEO. I have no prepared statement.

Mr. STEARNS. No prepared statement, okay. I'll start with the opening questions.

In your statement, as well as in members' here, words like manipulated, misled, scandal, scheme, deception, disguised earnings, circumvented, undermanned, undermined, market awareness, pervasive, these are the terms that have been used.

Freddie Mac's problems were discovered by the board of directors, as I understand. Is that correct?

Mr. FALCON. This all was uncovered initially as a result in a change in external auditors by the company.

Mr. STEARNS. Mr. Falcon, since your job is oversight, why didn't your office detect it first, since you had a fiduciary responsibility, as the oversight for the government, why wouldn't your office detect it, identify this problem in your normal accounting and oversight?

Mr. FALCON. That's a fair question, Mr. Chairman. We were aware of these transactions, but we weren't aware of the accounting for these transactions. These transactions, generally, did not pose additional risk to the company from a safety and soundness perspective. We would have prevented them from entering into them had we understood the purpose of these transactions.

So we're familiar with them from a risk management standpoint, but the accounting for these transactions is really what's at issue here.

Mr. STEARNS. Do you think your office has enough people, enough expertise to identify these problems?

If you were going to say to someone today, by golly, this is what I want, so this won't happen again, what would you say?

Mr. FALCON. I think what's required on the part of OFHEO, Mr. Chairman, is additional resources and expertise, not just across the board, but more specifically in the accounting area. Safety and soundness regulators generally do not secondarily certify that the financial statements—

Mr. STEARNS. Only the accountant?

Mr. FALCON. Right, only the external auditor does that.

Mr. STEARNS. So really your office could never detect this kind of mismanagement, misled, schemes, scandals, all these things. Your office could never have detected this?

Mr. FALCON. We weren't equipped to—

Mr. STEARNS. You weren't equipped to detect this.

Mr. FALCON. [continuing] this kind of accounting misconduct.

Mr. STEARNS. Okay.

Mr. FALCON. May I add, we are working to bring this expertise on board in the agency beginning with the creation of an office of chief accountants which Ms. DeLeo—

Mr. STEARNS. I'm just trying to understand how it occurred and I'm trying—my next question goes to what our jurisdiction is which is FASB.

Do you think FASB has to change its "mixed attribute" accounting rule? Because as a taxpayer, all of Americans cannot take their income and segment it. Say I'll report half of this \$50,000 this year and the other \$30,000 at a later year, when I have a low income, so then I don't have to pay taxes on \$80,000 or \$60,000 or \$50,000. I'll just show a very small percentage of this income this year and then I'll show it next year or 2 years. I'm not sure when, so that I don't have to pay the taxes. That could put you in jail as a taxpayer.

Yet, our corporations, and I understand what's being done by Freddie Mac is pretty much done throughout all of the corporations. Is that your understanding that most other corporations do the same thing that Freddie Mac—so Freddie Mac is not alone on this?

It's difficult for you to answer that.

Mr. FALCON. Right.

Mr. STEARNS. But I'm just saying what I hear. But let's forget that for the moment, but should the rules at FASB be changed to prevent corporations, Freddie Mac, from segmenting and mixing their assets so that they don't have to pay and show in a timely fashion these revenues?

Mr. FALCON. I certainly think with respect to Freddie Mac, the accounting standards were clear to the company, but what we saw was a disregard for the accounting standards and the entering of transactions to shift earnings. Now with respect to the general issue about the accounting standards which you mentioned, I'm not prepared to answer that question, but I think Ms. DeLeo can elaborate on that for you.

Mr. STEARNS. Sure. I need somebody who is familiar with this to say FASB's accounting standards are not working. Is that true?

Ms. DELEO. I think we would probably all agree that there are flaws in the current accounting standards that are out there.

Mr. STEARNS. So the accounting standards from FASB are flawed in this area?

Ms. DELEO. Let me preface that. In that regard they are moving with their financial instrument, their fair value financial instrument in that area and I think that will certainly help.

Mr. STEARNS. Not solved, but help.

Ms. DELEO. But help, exactly. But the root causes of what we saw at Freddie Mac were not the existing accounting standards. It was the inability to implement and apply those standards correctly that created these problems.

Mr. STEARNS. The Doty report indicated that one of the main activities of the head of the financial engineering was to find and exploit anomalies, irregularities in GAAP. Now how do we stop that? I mean tell me what is Freddie Mac's department of financial engi-



neering? I understand what the finance department is. What's financial engineering in your estimation?

Ms. DELEO. May I address the first part of your question?

Mr. STEARNS. Sure, absolutely, yes.

Ms. DELEO. I think what we normally would have seen in a corporation is three areas, a strong internal accounting group, a strong internal audit staff and external auditors. What we found at Freddie was weaknesses in all of those areas, so when that existed you're going to have a situation where you're going to have misapplications of GAAP.

Mr. STEARNS. Okay, is financial engineering a department, generally, that's okay? It sounds like a financial engineering department is one to exploit and—find and exploit anomalies in GAAP.

Ms. DELEO. Well, that particular department was, I guess that name is a misnomer, but had you had a strong accounting—

Mr. STEARNS. You wouldn't need a financial engineer.

Ms. DELEO. And they would have prevented or turned down anything that that group was working on that would have misapplied GAAP.

Mr. STEARNS. Fannie Mae is also under your jurisdiction, Mr. Falcon.

Mr. FALCON. Yes.

Mr. STEARNS. And are you saying here today that there's no problems in the GAAP accounting compliance in that corporation too today?

Mr. FALCON. I'm not prepared to say that at this moment. We do not, as I said, secondarily, review accounting statements for compliance for GAAP and so we are about to undertake an extensive review of Fannie Mae to determine and make sure that there aren't any problems at Fannie Mae.

Mr. STEARNS. My time has expired.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman. I appreciate your good questions, too. I was going to start really the same way. This is a scathing statement that you made. Some of the language is pretty harsh in here, rightfully so, I think, but obfuscate particular policies, disdain for appropriate disclosure standards, misled investors, low regard for disclosure, obsession with steady stable growth and earnings at the expense of proper accounting policies and strong accounting controls, weak or nonexistent accounting policies and on and on.

It really led me to think really the same question. Since, as I understand OFHEO, you employ "a full range of supervisory and enforcement tools including examination, capital standards and prompt corrective action procedures." Is it simply just the lack of expertise or is it that in the past you have not been looking for the thing, since safety and soundness wasn't a concern that you weren't looking at all for the things that we have subsequently have been discovered?

Mr. FALCON. This accounting misconduct is not something that we would—you have to review their financial transactions and how they applied GAAP to those transactions to be able to protect against this type of conduct. And this conduct by its very nature isn't obvious or made plain to the public, investors or regulators. You have to go in and try to find this type of misconduct. And with

that and an accounting review by our agency on a regular basis, we can't do that which is why we're changing this part of our oversight program over these two enterprises. We will begin with use of our Office of Compliance as well as an Office of Chief Accounting to begin to spot check and review the implementing of the accounting standards.

Ms. SCHAKOWSKY. Now if they were forced to register with the SEC, the SEC would do that kind of work, is that correct? And let me just ask, and do you support legislation that would require, since they've been so lackadaisical and to date have not registered with the SEC.

Mr. FALCON. I think it became very clear to us, Congresswoman, in the course of this investigation that a system of voluntary disclosure standards is not adequate and so I do support the repeal of the company's 1933 and 1934 exemptions.

Ms. SCHAKOWSKY. Freddie Mac has been fined \$125 million. I want to ask you, and I don't know the answer to this, is this sufficient? I think what Americans are feeling right now is that some of these scandals go largely unpunished that while there is a little burst of energy at first and isn't this terrible and a lot of finger pointing and wagging that in the end it's maybe a slap on the wrist and that's about it.

We have a particular responsibility here. It's one thing to talk about Enron or some private, totally private company and isn't this awful and there should be more consequences, but still we, because it's a GSE, have particular responsibility. Is this sufficient so far in the way of a fine?

Mr. FALCON. You mentioned the adjectives that were in the report and the testimony about the type of conduct they discovered. I'm not pleased about that kind of conduct at all, any more than you are.

As you pointed out, these are government-sponsored enterprises. They live off of a public trust to fulfill their mission.

Ms. SCHAKOWSKY. Exactly.

Mr. FALCON. And if that public trust is violated, then our housing finance system is at risk which is why we are taking as strong an action as possible. I think the fine of \$125 million was a very substantial fine, one of the largest ever imposed by a safety and soundness regulator for misconduct. Top management has been replaced. You'll see over the course of the next year a turnover on the board and we are implementing a very strong remedial plan for the company. This week, we'll decide whether or not the company shouldn't hold additional capital pending its compliance with the remediation plan.

Ms. SCHAKOWSKY. I thank you and thank you, Mr. Chairman.

Mr. STEARNS. I thank my colleague. I would just say to her question that I think Freddie Mac had \$900 billion income and probably had a profit of \$10 billion, so \$125 million is a very, very small fee of fine and the gentleman from Arizona.

Mr. SHADEGG. Thank you, Mr. Chairman. I appreciate the questioning of my colleagues. I think you've done an excellent job of bringing out the points. I guess I'm intrigued by Ms. DeLeo, a comment you just made, that I think is almost pervasive here and if I'm misreading what you intended, correct me.

You said that it was the result of an inability to apply the standards and I jotted down the words very quickly. I guess I think that's a mischaracterization, because I don't think it was an inability. I think it was a chosen intent not to apply the standards. I don't think it was because they couldn't apply the appropriate standards. I think they read the standards carefully. I think they understood what the standards required. I think they figured out how to deceive, how to get around the standards through deception to achieve the end they wanted and that's the course they pursued, which means the fundamental issue for me is not are the standards appropriate and we already concede there are some problems with the standards, but rather, at least as I perceive it, it's not a question of whether the standards are appropriate. Indeed, they may be flawed to some degree.

There may be technical loopholes that shouldn't be there, but it seems to me the issue really is what's the culture? If the culture is you're going to set down a series of standards for us, and we're going to look carefully at the letter of those standards and we're going to manipulate them whatever way we can to report what we'd like to report and still comply with the letter of the law; if they claim they can do that, but we'll be able to get away with doing what we wanted to do, then I don't think the biggest problem is fixing the standards, I think the biggest problem is changing the culture. And your word "inability to apply the standards" troubles me.

Am I misperceiving? Do we see this issue differently?

Ms. DELEO. It's where the inability is used. My comment was in reference to the expertise in the accounting area. Freddie did not have the proper expertise to be able to interpret and apply those standards. That allowed individuals outside accounting to be able to manipulate and work around that.

I do agree with your comment.

Mr. FALCON. The point is, Congressman, that the lack of a strong internal audit function, internal accounting office in the company, allowed those outside that office to work around the accounting rules without there being someone internal to police their conduct and additionally with the external auditor, not objecting to this conduct, in fact, Arthur Andersen was involved in day to day accounting decisions in the company, so in essence, they were auditing their own work. The lack of this expertise internal to the company allowed those in the financial transactions area to just disregard accounting standards.

Mr. SHADEGG. I agree very strongly with the comments of the Ranking Member with regard to the fact that this is unlike the Enron scandal or other public or other private entity scandals. This one is at our doorstep and I am deeply concerned that absent some draconian steps, we're not going to be able to regain the credibility of the public. And I guess you have already said that you think the exemption from the 1933 and 1934 acts should be repealed? What other steps do you think are necessary to regain credibility?

Mr. FALCON. I think we've recommended some very good corporate governance reforms for the companies in our report, Congressman. We will soon promulgate the corporate governance rule which will implement these.

We found that there was a conflict between one individual serving as both the Chairman of the Board and CEO of the company. The role of the Board is to oversee the management of the company and when you have a strong Chairman of the Board, what we found with Freddie Mac is that that is not a best practice and it allows that individual to sort of weaken the Board's oversight function.

We are also going to require that the Board become more active and meet more frequently. This company is still meeting just four times a year and a company as sophisticated as this I think needs a more active Board. So we are moving to implement more corporate governance reforms.

Mr. SHADEGG. Some believe that if there had not been a change in the auditor, there wouldn't have been a restatement and none of this would have been caught and Freddie Mac would still be engaged in what it was doing. Do you share that view?

Mr. FALCON. That may be. Absent, our lack of resources and expertise in this accounting area and our lack of a mission in looking at how they applied GAAP in their financial statements, that could be which is why we have to move in that direction, begin to take on that responsibility.

Mr. SHADEGG. So to those who say your criticism of the entity isn't very credible because you guys didn't catch this, your response is we didn't have the duty and we didn't have the resources?

Mr. FALCON. Right. I'm reluctant to say something which sounds like it wasn't our job, but in essence, the safety and soundness of a company requires the cooperation of not just the regulator. Management of the company has to run the company soundly. The Board of Directors has to fulfill its obligations and the external auditor has to do its job properly. The role of the regulator is to try to oversee that all of those functions are done right. Without the resources and expertise related to the accounting area, we could not properly oversee the work of the external auditor.

I don't think we're looking to implement a system where we secondarily certify the financial statements. More importantly, we need to make sure that when new accounting standards are brought on line, like this one involving FAS 133, that we have the capacity to make sure that the implementation of this accounting standard is done properly and that on an on-going basis the company is not using transactions to do anything like shifting earnings.

Mr. SHADEGG. I'm compelled to conclude by just noting, I think it's Paul Harvey who sometimes self-government without self-discipline won't work. It looks to me like the situation here and the situation with the Enron problems is people who are entrusted with responsibility, there simply isn't a big enough army of overseers to watch them all. If their basic motivation is deceit, then it's going to be tough.

Mr. FALCON. Right.

Mr. SHADEGG. We're going to have problems with them and it's really unfortunate because vastly expanding the regulatory structure just means you need smarter people to get around it and I'm not certain that's a very good answer. We need a culture of people

who say I'm not looking at the letter of the law. I'm looking at my obligation to the people for whom the law was intended to protect.

Mr. Chairman, I yield back the balance of my time.

Mr. STEARNS. I thank the gentleman. The gentleman from Ohio.

Mr. STRICKLAND. No questions.

Mr. STEARNS. No questions. The gentlelady from California.

Ms. SOLIS. Actually, just more of a comment. I too am overwhelmed to hear all these statements being made and I would just ask the reforms that you are proposing, do you really believe that that's going to require a change in behavior?

Mr. FALCON. I think part of the problem has generated from, as we said in the report, a tone at the top. And aside from all of the additional corporate governance requirements and statutory changes that we're requesting to strengthen oversight, we also fundamentally need to make sure that there is a new corporate culture that's brought about, where the tone at the top is one of strict integrity and compliance with rules and regulations. That's something that we are looking at very closely and tracking very closely and so far, we're encouraged by the new tone we're seeing by the new CEO and Chairman that was brought into the company and the activities that the company has taken by way of remedial reforms.

So we have to make sure that there's a new corporate culture. Along the lines of what Mr. Shadegg said, everyone has to fulfill their own responsibilities.

Ms. SOLIS. I would just add that obviously these institutions, Fannie Mae and Freddie Mac, play an essential role in communities like mine where we are in a phase where we're not able to secure enough capital to provide sufficient housing for low income and middle income families and the integrity of these programs, obviously, are very reflective of what we as Members of Congress support. We have different activities, in fact, with some of these organizations in our Districts, so that doesn't sit well for us when we have to go home and our constituents are reading about all this mismanagement and somewhat collusion—I hate to use that word, but that's what it sounds like to me from reading your testimony, that there's collusion on the part of the accounting firms with these organizations.

We're not satisfied with that and I know there's legislation being proposed and we're certainly going to be monitoring that and hopefully, we're going to see that there is more transparency made available to the public.

Mr. FALCON. I fully support that, Congresswoman.

Mr. STEARNS. I thank my colleague. I was just going to ask a couple of questions before you leave, Mr. Falcon and if anyone else would like to ask a few additional follow-up questions.

You issued a fine of \$125 million and I think you also were trying to get some of their stock options or some of their compensation back. How successful have you been on that?

Mr. FALCON. We're taking an action that's pending right now that I can't discuss too much because it's the subject of litigation. We are moving to require that the former Chairman of the Board and CEO, as well as the Chief Financial Officer of the company, be terminated for cause which could result in their losing approxi-

mately \$25 million or more, in addition to some recovery of past bonuses and other benefits they received.

Mr. STEARNS. How much would that add up to? What would be the whole package that you're asking that they return? \$25 million plus bonuses, plus stock options?

Mr. FALCON. For these two individuals, I think the total might approach possibly \$32 million.

Mr. STEARNS. \$32 million you're asking for a return of?

Mr. FALCON. Right. In the case of another individual, the former Vice Chairman of the company, he was terminated for cause which resulted in his loss of substantial severance benefits. What we're trying to do, Mr. Chairman, is set a clear standard that if top management of a company engages in misconduct, those individuals should be terminated for cause and not just allowed to resign and walk away with the financial windfall.

We're being challenged on it, but it's a principle that we're going to continue to fight for.

Mr. STEARNS. The other point I wanted to make is you gave a fine to Freddie Mac, but the question I have, shouldn't the people who are involved with the accounting, the engineering—financial engineering, shouldn't some of these people who are not the CFO and the president and so forth, chairman of the board, shouldn't these people also be fired in your opinion and why haven't—have you recommended that because the people that are at the highest level of management can set the culture, but the people who execute the things that have led to the scandal, shouldn't they also be terminated?

Mr. FALCON. And some of them have, Mr. Chairman, some of them have.

Mr. STEARNS. Have you recommended and identified who those folks were?

Mr. FALCON. Yes. We've been working with the company, now the former head of their investment at finance division which structured many of these transactions, became the CEO of the company. At the direction of myself, that individual has been replaced.

Mr. STEARNS. Ms. DeLeo, do you also feel that the people who are in the sort of second tier of management should also be eliminated and fired?

Don't you think there's culpability there as well as the top people?

Ms. DELEO. I think that's a decision that we have to look at and that Freddie has to look at.

Mr. STEARNS. Are you looking at that now and have you identified those people and know what they did wrong?

Ms. DELEO. Yes, we have been.

Mr. STEARNS. Because the Doty report would indicate that these folks were exploiting these anomalies and I think if they're exploiting them that that's wrong and they should be implicated too and I'm just wondering, we don't hear about the termination of those people. Had there been many terminations by those folks?

Mr. FALCON. There have been at least two dozen individuals, I believe, who have faced the range of sanctions from reprimands to loss of bonuses to termination for the company, depending on the level of conduct that they engaged in.

Mr. STEARNS. Okay. Anyone else? Yes.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman. Mr. Falcon, in your statement, you talk about executive compensation and I was wondering—I was hoping in asking if we could get a copy of the OFHEO study of executive compensation of Freddie and Fannie which has been presented to the Financial Services Committee.

I understand that Fannie Mae has retained the services of former Clinton prosecutor Ken Starr who is reportedly trying to keep the Financial Services Committee from releasing that report and so I am asking you if we can get a copy of that report for the record.

[The report is retained in subcommittee files.]

Mr. FALCON. I'd be happy to provide it to you, to the Committee, Congresswoman. The information was information on the salary and total benefits of the senior most individuals of the two companies. We provided it to the House Financial Services Committee with the understanding that it is confidential information and I believe we can provide it to you as well.

Ms. SCHAKOWSKY. To the extent that you say that compensation of senior executives contributed to the improper accounting and management practices of the enterprise, I would think that at the very least it should be provided to us, but also, I would think that the public has a right to see that as well.

Mr. FALCON. What that is referencing to is their bonus was structured in a way that I think 40 to 60 percent of the bonuses were dependent upon achieving these earnings targets. That's what that is in reference to. But we'll certainly work to fulfill your request, Congresswoman.

Ms. SCHAKOWSKY. And what is the rationale for it being confidential?

Mr. FALCON. Only the information related to the top five individuals at the company is subject to the public disclosure standards. It's the same as for every corporation. This list went beyond the top five individuals and included compensation for individuals that are covered by our excessive compensation regulation. It's a list of approximately 20 or so individuals for each company.

Ms. SCHAKOWSKY. Well, I think it is worth having a discussion about what portions at the very least of that should be made public. The issue is one, I think, that should be open to scrutiny by more than just members of the Committee, but I thank you for your willingness to make it available to us.

Mr. ISSA. Would the gentlelady yield?

Ms. SCHAKOWSKY. Yes.

Mr. ISSA. If you struck the names of those 20 individuals and released the information as to their programs and incentive without personal information, would that eliminate the concern of privacy and allow for more broad evaluation?

Mr. FALCON. Possibly, Congressman. May I ask that our counsels work with the Committee on this issue?

Mr. ISSA. Would the gentlelady consider that acceptable as a starting point?

Ms. SCHAKOWSKY. Well, as a starting point, but I still think that full disclosure is in order.

And let me ask you this, have the executive compensation practices changed at Freddie Mac since your report and since all of these problems have been revealed?

Mr. FALCON. Yes, they have, Congresswoman. The emphasis on short-term earnings is no longer part of that compensation, the bonus of that structure. They have worked to correct that problem.

Ms. SCHAKOWSKY. Thank you. I look forward to seeing it.

Mr. STEARNS. Thank you. The gentleman from California declines. Okay. I think there's no one else, so Mr. Falcon and Ms. DeLeo, we appreciate both of you being here and we'll go to the next panel.

Thank you.

Mr. Martin Baumann, Chief Financial Officer, Freddie Mac. We welcome you to the table and we appreciate your participation and look forward to your opening statement.

[Off mic conversation.]

Mr. STEARNS. Maybe I'll ask counsel if there's any legal restraining order, but we'll take that when we get to report. We'll move forward.

Mr. Baumann, let me welcome you and we appreciate your opening statement.

**STATEMENT OF MARTIN F. BAUMANN, CHIEF FINANCIAL  
OFFICER, FREDDIE MAC**

Mr. BAUMANN. Thank you, Chairman Stearns, Ranking Member Schakowsky and members of the subcommittee. It's a pleasure to be here this morning.

My name is Martin F. Baumann. I am the Executive Vice President and Chief Financial Officer of Freddie Mac. I joined Freddie Mac in April 2003. I was hired to build a strong finance function within Freddie Mac and to restore confidence in the company's financial reporting. I am committed to developing an exemplary finance function that produces accurate, timely, well-controlled and transparent financial reports.

Prior to joining Freddie Mac, I worked at PriceWaterhouseCoopers for more than 30 years as a partner, as deputy chairman of the World Financial Services Practice, and as the Global Banking Leader.

I welcome the opportunity to be here today to provide Freddie Mac's views on the use of fair value-based measures, to discuss the accounting errors addressed by our restatement and to discuss Freddie Mac's on-going corporate-wide remediation program.

Freddie Mac has been working hard to regain the confidence of all of our stakeholders. Last year we completed the restatement and began implementing a corporate-wide remediation program to ensure that the accounting and financial control issues that led to the need for the restatement will never happen again.

Today, Freddie Mac is focused on bringing our financials current. We believe our accounting policies for the restatement periods are fully compliant with GAAP and we are completely committed to using GAAP as the primary underpinning for our on-going communications with our shareholders and other interested parties.

Freddie Mac's mission is to ensure a stable supply of low cost mortgages for America's families, whenever and wherever they



need them. Despite our difficulties last year, we maintained our focus on fulfilling our special responsibilities to home buyers, the public, Congress and investors.

Freddie Mac has the right leadership to attain our goals in our new Chairman and CEO, Dick Syron. Dick has extensive expertise and is committed to our important public mission and to regaining the full confidence of the public and our stakeholders.

Before I comment on the accounting errors addressed by Freddie Mac's restatement of prior years' results, I would like to offer some views on principle-based accounting, fair value and GAAP.

Mr. Chairman, as I stated during my appearance before this subcommittee last summer, I am fully supportive of your efforts to move GAAP to a principles-based framework. I believe that a principles-based approach could ensure that all reporting companies meet the substance and not simply the form of accounting rules.

The move to greater use of fair values is another important step in accounting. Over the years, the FASB has made significant progress toward increasing the use within GAAP of fair value-based measures for financial instruments. Freddie Mac is committed to providing investors with the information they need to understand how we view and manage our business.

To that end, we are preparing to become one of the first financial institutions to provide investors with a full, fair value balance sheet on a quarterly basis which will show mark-to-market gains and losses on our business and provide investors with an additional measurement tool, along with our GAAP financial statements.

The restatement was a significant step in Freddie Mac's progress toward achieving accurate and timely financial reporting. We're now completing our annual report for 2002 and the latest stockholders' meeting will be held on March 31, 2004. We completed the restatement while maintaining our business fundamentals and delivering on our congressional mandate to make mortgage credit more available for America's families.

We remain fully committed to our mission of helping make housing more affordable for more Americans and maintaining liquidity in the housing market which, for the past several years, has bolstered the U.S. economy.

The restatement did not affect the fundamental strength of Freddie Mac's business. Freddie Mac's business operations remain strong and interest rate risk and credit risk remain low. Our risk profile remains conservative with an average duration gap of zero for December 2003, unchanged since October.

For anyone not familiar with the concept of a duration gap, a zero duration gap means that, in general, changes in the value of assets due to changes in interest rates are expected to be equally offset by changes in the value of liabilities and derivative contracts.

Now I'd like to comment on the accounting corrections made in connection with the restatement of Freddie Mac's financial statements. The accounting errors addressed by the restatement fall into five categories: securities classifications, accounting for derivative instruments, asset transfers and securitizations, valuation of financial instruments, and other corrections. Detailed information on these accounting errors is provided in our restatement press release.

Freddie Mac has accepted the conclusions of the report of the Board's independent investigative counsel, Baker Botts. That report found that the principal factors contributing to the restatement were lack of sufficient accounting expertise and internal control and management weaknesses as a consequence of which Freddie Mac personnel made numerous errors in applying GAAP.

In addition, certain capital market transactions were executed and certain accounting policies were implemented with a view to their effect on earnings in the context of Freddie Mac's goal of achieving steady earnings growth. Also, certain reserve accounts and other adjustments which were known departures from GAAP, but were not considered to be material at the time, were also made with a view to their effect on earnings.

In addition to completing the restatement of prior year financial results, Freddie Mac is currently engaged in an active remediation program that began in the spring of 2003 when the governance committee of the Board of Directors asked me to develop a remediation program to ensure that the factors contributing to the need for the restatement would not recur. Our program combines the steps required by the December 9, 2003 consent order between Freddie Mac and OFHEO, Freddie Mac's safety and soundness regulator, with the actions that were underway in our pre-existing remediation program.

The remediation program demonstrates our commitment to create a corporate culture in which the type of problems that led to the restatement will never happen again.

We are building upon our very significant efforts to improve the quality and depth of internal accounting personnel, the strength of the accounting function and management oversight of that function. This has been and continues to be a key priority of the company in the wake of the restatement.

We are also working to create and implement new infrastructure and systems to ensure the quality, integrity, transparency and timeliness of our financial reporting. Together with Freddie Mac's new chairman and CEO, as well as our senior management team, I will ensure that we set the right tone at the top, one that promotes integrity, high ethical standards and the importance of compliance.

Freddie Mac's Board of Directors, current management team and employees are continuing to improve our reporting, governance and financial controls. Now that the restatement is complete, we are focused on bringing our financials up to date. Our objective is to release quarterly and full year 2003 results by June 30, 2004 and to provide the 2003 annual report and hold the related stockholders meeting as soon as possible thereafter.

Freddie Mac remains irrevocably committed to completing the process of voluntarily registering its common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934, with the objective of completing the process, as soon as possible, after the company's return to timely reporting.

Freddie Mac recognizes the importance of transparent accounting and reporting standards and we're committed to providing investors with the information they need who understand how we view and manage our business. We have already taken significant steps

toward achieving our goal of exemplary financial reporting and controls. The work that we have done and continue to do as a part of the remediation program will enable us to reach that goal.

As we complete this work, we are continuing to fulfill our important public mission, maintain our safety and soundness and meet our business objectives.

Thank you for the opportunity to appear today. I look forward to working with you and the members of this subcommittee, Chairman Stearns, and Congresswoman Schakowsky, as you focus on financial accounting standards. I will be happy to answer any questions the subcommittee might have.

[The prepared statement of Martin F. Baumann follows:]

PREPARED STATEMENT OF MARTIN F. BAUMANN, CHIEF FINANCIAL OFFICER, FREDDIE MAC

Thank you, Chairman Stearns and Members of the Subcommittee. It is a pleasure to be here this morning.

My name is Martin F. Baumann. I am the Executive Vice President and Chief Financial Officer of Freddie Mac. I joined Freddie Mac in April 2003. I was hired to build a strong finance function within Freddie Mac and to restore confidence in the company's financial reporting. I am committed to developing an exemplary finance function that produces accurate, timely, well-controlled and transparent financial reports.

Prior to joining Freddie Mac, I worked at PricewaterhouseCoopers for more than 30 years as a partner, as deputy chairman of the World Financial Services Practice, and as the Global Banking Leader. At PricewaterhouseCoopers, I was responsible for certifying the financial statements of some of the largest United States and international banking, insurance and other financial services companies.

I welcome the opportunity to be here today to provide Freddie Mac's views on the use of fair value-based measures within generally accepted accounting principles (GAAP), to discuss the accounting errors and related corrections addressed by our restatement, and to discuss Freddie Mac's ongoing corporate-wide remediation program.

Last year was a challenging year for Freddie Mac. In January, we announced a restatement of prior-year earnings and in June, our Board of Directors made changes in the company's senior management.

Freddie Mac has been working hard to regain the confidence of all of our stakeholders. We have completed the restatement of prior-year financial results and we are implementing a corporate-wide remediation program to ensure that the accounting and financial control issues that led to the need for the restatement will never happen again.

Freddie Mac's mission is to ensure a stable supply of low cost mortgages for America's families—whenever and wherever they need them. We recognize our special responsibility to homebuyers, the public, the Congress and investors. Despite our difficulties last year, we maintained our focus on fulfilling these important responsibilities.

Today, Freddie Mac is focused on bringing our financials current. We are building an environment that will allow us to provide comprehensive and understandable information about our company, incorporating the highest level of financial transparency, accounting controls, compliance, and professional standards.

GAAP is the foundation for all financial reporting. We believe Freddie Mac's accounting policies for the restatement periods are fully compliant with GAAP, and we are completely committed to using GAAP as the primary underpinning for our on-going communications with our shareholders and other interested parties.

Freddie Mac has the right leadership to attain our goals in our new Chairman and Chief Executive Officer, Richard F. Syron. Dick has extensive industry expertise, and corporate leadership and financial experience, having led a Fortune 500 firm, served as chairman and chief executive officer of the American Stock Exchange, and served as the president of the Federal Reserve Bank of Boston and as president of the Federal Home Loan Bank of Boston. He is committed to our important public mission and to regaining the full confidence of the public and our stakeholders.

Before I provide an overview of the accounting errors and related corrections addressed by Freddie Mac's restatement of prior-year results, I would like to offer some views on principles-based accounting, and fair value and GAAP.

#### PRINCIPLES-BASED ACCOUNTING

The Securities and Exchange Commission and the Financial Accounting Standards Board (FASB), among others, have been studying the potential efficacy of adopting a U.S. financial reporting system based on principles-based standards.

Mr. Chairman, as I stated during my appearance before this Subcommittee last summer, I am fully supportive of your efforts to move GAAP toward a principles-based framework. I believe that a principles-based accounting framework holds the potential to improve the representational faithfulness of financial reporting under U.S. GAAP. A principles-based approach could ensure that all reporting companies meet the substance, and not simply the form, of accounting rules.

I look forward to working with you, Mr. Chairman, and with the Members of this Subcommittee as you work toward this new accounting framework.

#### FAIR VALUE AND GAAP

Fair value measurement is having an increasingly important role for purposes of GAAP financial reporting and disclosure. Over the years, the FASB has made significant progress toward increasing the use within GAAP of fair value-based measures for financial instruments.

Capital markets participants have expressed support for fair value measurement concepts. And, fair value measures are of increasing interest and importance to our investors. Freddie Mac is committed to providing investors with the information they need to understand how we view and manage our business, so that investors can value our business fairly and accurately. To that end, Freddie Mac is preparing to become one of the first financial institutions to provide investors with a full fair value balance sheet on a quarterly basis, which will show mark-to-market gains and losses on our business and provide investors with an additional measurement tool, along with our GAAP financial statements.

#### COMPLETING OUR RESTATEMENT AND FULFILLING OUR MISSION IN 2003

On November 21, 2003, the Freddie Mac Board of Directors and our management team announced the release of the company's restated and revised financial results for the years 2000 through 2002. The restatement was a significant step in Freddie Mac's progress toward achieving accurate and timely financial reporting.

Freddie Mac completed this restatement while maintaining our business fundamentals and delivering on our congressional mandate to make mortgage credit more available for America's families. For more than 30 years, Freddie Mac has helped meet the home financing needs of families at all income levels, in all communities, and in all parts of the country. Meeting the annual affordable housing goals is a key aspect of meeting our mission. In fact, Freddie Mac has successfully met all of the permanent affordable housing goals since they were established by the Department of Housing and Urban Development.<sup>1</sup>

We remain fully committed to our mission of helping make housing more affordable for more Americans and maintaining liquidity in the housing market, which, for the past several years, has bolstered the US economy.<sup>2</sup> In fulfilling our mission, Freddie Mac plays an important role in maintaining the strength of the housing sector, a sector that directly accounts for approximately 15 percent of the Gross Domestic Product (GDP) and has accounted for 36 percent of the growth in GDP over the last two years.<sup>3</sup> Furthermore, we have contributed to growth in the economy by helping homeowners refinance into lower rate mortgages and redeploy some of their housing equity.<sup>4</sup> These benefits are directly attributable to the long-term, prepayable fixed rate mortgage, which our activities make widely available.

<sup>1</sup> Final calculations for the 2003 goals have not yet been completed.

<sup>2</sup> According to the National Association of Realtors' announcement this past Monday, January 26, 2004, sales of previously owned homes set a record high in 2003, totaling 6.1 million—a 9.6 percent increase from the previous record set in 2002. In addition, U.S. census data through November 2003 show that new home sales continued to increase over 2002 and 2001 sales.

<sup>3</sup> These percentages are based on data published by the Bureau of Economic Analysis, U.S. Department of Commerce for 1996 through 2003 and data for the same years available upon request from Freddie Mac.

<sup>4</sup> See Remarks by Federal Reserve Chairman Alan Greenspan before the Annual Convention of the Independent Community Bankers of America, Orlando, Florida, March 4, 2003, available online at [www.federalreserve.gov](http://www.federalreserve.gov).

The restatement did not affect the fundamental strength of Freddie Mac's business.

Freddie Mac's business operations remain strong and interest-rate risk and credit risk remain low. Our risk profile remains conservative, with an average duration gap of zero for December 2003, unchanged since October. In fact, we maintained a low duration gap throughout 2003.

Now, I would like to provide an overview of the accounting corrections made in connection with the restatement and revision of Freddie Mac's financial statements.

#### ACCOUNTING CORRECTIONS

Freddie Mac has classified the accounting errors and related corrections addressed by the restatement into five categories. These five categories involve subjective judgments by Freddie Mac regarding classification of amounts and particular aspects of these errors may fall within one or more of these categories. While these classifications are not required under GAAP, Freddie Mac believes these classifications may assist investors in understanding the nature and impact of the corrections made in completing the restatement.

These errors and accounting changes are described in detail in Freddie Mac's press release announcing the restatement, and in particular, in Appendix II, "Detailed Discussion of Accounting Errors and Other Changes" and Appendix III, "Fair Value and Interest-Rate Risk Measures." A copy of our press release and the accompanying appendices is available online at [www.freddiemac.com](http://www.freddiemac.com).

#### SECURITY CLASSIFICATION

Freddie Mac is required to classify its investments in one of three categories—held-to-maturity, available-for-sale, or trading—primarily based on management's investment intention at the time the company acquires a security. During the restatement period, Freddie Mac engaged in transactions involving securities in the held-to-maturity category that management accounted for as financings, but should have accounted for as sales. Accordingly, GAAP requires management to reclassify all securities previously classified as held-to-maturity into the available-for-sale category and to discontinue use of the held-to-maturity accounting classification for all securities until at least 2004, approximately two years after the last transaction giving rise to this error.

During the restatement period, management also transferred mortgage-related securities that it had designated for accounting purposes as trading into both the held-to-maturity and available-for-sale classifications when it should have retained the trading classification for these securities. Management has reversed this misclassification and recorded unrealized gains and losses on the securities in earnings for the appropriate period.

#### *Accounting for Derivative Instruments*

Freddie Mac applies risk-management strategies with strict discipline. We use derivatives to manage interest-rate risk associated with financial assets and liabilities. We believe the accounting issues associated with derivatives identified in the restatement have not affected the performance of the company's derivatives from a risk management perspective. As part of the restatement, management has corrected several errors in the company's accounting for derivatives. These corrections consisted of removing from earnings previously reported gains and losses related to hedged items for a portion of the company's fair value hedges and recording in earnings previously deferred gains and losses for a portion of the company's cash flow hedges.

#### *Asset Transfers and Securitizations*

Whenever Freddie Mac sells Mortgage Participation Certificates (PCs), GAAP requires the guarantee fee stream to be recorded as a retained interest (the guarantee asset) and the associated obligation, including the guarantee of payments of principal and interest to security holders, as a liability (the guarantee obligation). Freddie Mac failed to do this. To correct this error, management has recorded the guarantee asset and guarantee obligation for PCs and other mortgage securities sold by the company during the restatement period and included these amounts in the determination of gain or loss on sale. Subsequent to the sale, Freddie Mac has reported the guarantee asset and obligation at fair value with changes included in earnings.

#### *Valuation of Financial Instruments*

During the restatement period, Freddie Mac made numerous errors in estimating the fair value of the company's derivatives and securities. Management has cor-

rected these errors in estimating fair value as well as other errors identified after extensive review of valuation methodologies and results. In addition to the corrections affecting the financial statements, management has incorporated the results of this re-valuation in Freddie Mac's Fair Value Balance Sheets as of December 31, 2002 and 2001.

#### *Other Corrections*

During the restatement process, management identified numerous other accounting policies and practices requiring correction, and has taken corrective action. These other corrections are discussed in the restatement press release available online at [www.freddiemac.com](http://www.freddiemac.com).

#### REMEDIATION PROGRAM

In addition to completing the restatement of prior-year financial results, Freddie Mac is currently engaged in an active remediation program. This program combines the steps required by the December 9, 2003 Consent Order between Freddie Mac and OFHEO, Freddie Mac's safety and soundness regulator, with the actions that were underway in our preexisting remediation program.

Our remediation program began in the spring of 2003 when the Governance Committee of the Board of Directors asked me to develop a remediation program to ensure that the factors contributing to the need for the restatement would not recur. Thereafter, the Board of Directors approved a comprehensive remediation program that has been—and is—effecting far-reaching changes in the company's financial reporting, control and management functions.

The Consent Order added further key items to our existing remediation program resulting in an enhanced comprehensive remediation program designed to ensure the integrity of Freddie Mac's financial reporting, controls and governance, and also to prevent a recurrence of the problems that led to the need for the restatement.

The activities we have already undertaken as part of the remediation, and our continuing plans, including fulfilling the requirements of the Consent Order, demonstrate our commitment to create a corporate culture in which the type of problems that led to the restatement will never happen again.

#### KEY REMEDIATION STEPS

Freddie Mac is building upon its very significant efforts to improve the quality and depth of internal accounting personnel, the strength of the accounting function, and management oversight of that function. This has been, and continues to be, a key priority of the company in the wake of the restatement.

The company has added over 100 professionals in the accounting, reporting and control areas, including a significant number of new officers and senior managers.

We have also retained leading experts in the areas of public disclosures and corporate governance to assist the company in designing and implementing processes and practices in these areas. In October 2003, we hired a Senior Vice President—Chief Compliance Officer who is responsible for overseeing Freddie Mac's compliance with policies, procedures and practices, including compliance with laws and regulations.

Additionally, in October 2003, we created the position of Chief Enterprise Risk Officer.

We are also working to create and implement new infrastructure and systems to ensure the quality, integrity, transparency, and timeliness of our financial reporting.

Finally, we have taken steps to ensure that Freddie Mac's corporate culture promotes integrity, high ethical standards, and the importance of compliance. Virtually all of our employees have completed a corporate-wide training program on the company's Code of Conduct and the provisions of the Sarbanes-Oxley Act.

#### LOOKING AHEAD

Through the extraordinary efforts of Freddie Mac's Board of Directors, current management team, and employees, we have met the challenges of the past year, and we are looking forward to continuing to improve our reporting, governance, and financial controls.

Throughout this difficult and challenging period, Freddie Mac has focused on ensuring that we will emerge a stronger, more disciplined company. And, we have done so while remaining fully committed to fulfilling our mission.

We are bringing our financial statements current and building for the future. The company expects to provide an annual report for 2002 and has announced the related annual stockholders' meeting to be held on March 31, 2004. Our objective is to release quarterly and full-year 2003 results by June 30, 2004 and to provide the

2003 annual report and hold the related stockholders' meeting as soon as possible thereafter.

Freddie Mac remains irrevocably committed to completing the process of voluntarily registering its common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934, with the objective of completing the process as soon as possible after the company's return to timely reporting. Freddie Mac reaffirmed this commitment in a letter to Treasury Secretary John Snow on July 14, 2003, in our restatement announcement and in other public statements.

#### CONCLUSION

Freddie Mac recognizes the importance of transparent accounting and reporting standards and we are committed to providing investors with the information they need to understand how we view and manage our business. We fully support the Subcommittee's efforts to move toward a principles-based accounting framework.

While the restatement represented an important milestone, now that it has been completed, Freddie Mac is focused on bringing our financials up-to-date. We have already taken very significant steps toward achieving our goal of exemplary financial reporting and controls. The work that we have done, and continue to do, as part of our remediation program will enable us to reach that goal. As we complete this work, we will continue to fulfill our important public mission, maintain our safety and soundness, and meet our business objectives.

Thank you for the opportunity to appear today. I look forward to working with Chairman Stearns and the Members of this Subcommittee as you focus on financial accounting standards. I would be happy to answer any questions the Subcommittee might have.

Mr. STEARNS. Mr. Baumann, thank you very much and thank you for appearing and I think we're all encouraged now that you're the new CFO, that a lot of the changes will be made and that you'll stay on top of it.

Were you one of the auditors, not working for the company, but an outside auditor when this occurred?

In other words, what was your role, before you were CFO you said your experience was as an auditor.

Mr. BAUMANN. Yes.

Mr. STEARNS. Had you been involved with Freddie Mac in any way?

Mr. BAUMANN. I was a partner at PriceWaterhouseCoopers, with PriceWaterhouseCoopers for 33 years.

Mr. STEARNS. And PriceWaterhouseCoopers was their auditors?

Mr. BAUMANN. PriceWaterhouseCoopers became Freddie Mac's auditors in 2002, replacing Arthur Andersen. That's correct.

Mr. STEARNS. Okay, and when you talked to your colleagues back at PriceWaterhouse in your new position, did they ever tell you some things that they feel should still be done?

Mr. BAUMANN. PriceWaterhouseCoopers issues a variety of many recommendations to management, to the board about things that we need to do to improve the internal controls and accounting expertise at Freddie Mac. I've been meeting with the Price WaterhouseCoopers team that's on the ground, doing the work on a regular basis, listening to their recommendations and findings and trying to implement as many of those recommendations as we can, as quickly as we can to improve the accounting expertise and internal controls of the company.

Mr. STEARNS. Does Freddie Mac still have a financial engineering department?

Mr. BAUMANN. I don't know that Freddie Mac ever had a department that was——

Mr. STEARNS. Or just financial engineering——

Mr. BAUMANN. But we do not have any financial engineering department today. Our transactions are recorded completely in accordance with GAAP.

Mr. STEARNS. What happened to the head of the financial engineering that I talked to Mr. Falcon about earlier? Is he still there?

Mr. BAUMANN. As I said, I don't know about a financial engineering department, but let me say this, as part of the program to change prior management, the former CEO, the former Chief Operating Officer, the former Chief Financial Officer, the former Comptroller, former Chief Investment Officer, the former General Counsel and many other people in the company have been let go from the company.

Mr. STEARNS. But Mr. Falcon indicated there was a financial engineering department. He described what they did. It was confirmed by Ms. DeLeo, so my question is do you think that department still exists in maybe some kind of form? Is it still using its skill to influence earnings?

Mr. BAUMANN. There is no financial engineering component in the company today. I am responsible for all financial reporting of the company and I ensure that financial reporting is fully in accordance with GAAP and I have no responsibility for bottom line earnings. My job is to make sure that our financial results are reported in an unbiased, accurate, reliable and transparent way.

Mr. STEARNS. In your opening statement, I believe you said this, certain transactions were entered into with a review to influence toward influencing earnings. Is that true?

Mr. BAUMANN. I said certain transactions were entered into with the view to their effect on earnings, yes.

Mr. STEARNS. I'm not a security lawyer, but I would indicate that's code for securities fraud. If you're actually entering into a review toward influencing earnings, in your estimation are you still doing that?

Mr. BAUMANN. We are not entering into any transactions today with a view to their effect on earnings in terms of trying to influence what the accounting results will be.

Mr. STEARNS. But your statement has indicated that in the past that's what they were doing?

Mr. BAUMANN. The Baker Botts report that was done, the investigative report determined that certain capital markets transactions and certain reserve accounts were maintained with the view to their——

Mr. STEARNS. Influencing earnings. Now your 30 years with PriceWaterhouse wouldn't you interpret, if you met some people in a corporation doing that, you're an outside auditor coming in and they were using transactions and entering them primarily to influence earnings, wouldn't you consider that fraudulent today?

Mr. BAUMANN. Well, that was not my job at PriceWaterhouseCoopers. My job was to report on the financial statements and report matters if they were inappropriate to Securities and Exchange Commission and other regulatory authorities who would have the responsibility for making those determinations.

At Freddie Mac, there have been two investigations so far; one by the Baker Botts firm, one by OFHEO, who has issued a com-



prehensive report. There's an on-going investigation by the Securities and Exchange Commission, the U.S. Attorney's Office and there are more than 12 civil suits all looking at what the causes of the restatement were.

We focus every day on——

Mr. STEARNS. I understand. I'm just trying to look at this as an outsider because if I hear an accountant is trying to be competent and something occurs because he's incompetent, that's one thing. But if a person strictly is sitting there trying to influence earnings by manipulating transaction, I would think that's a securities fraud. But that's just based upon what you said in the past.

Let me ask you this, OFHEO's report states that no one at Freddie Mac took responsibility for public disclosures and this led to inaccurate financial reporting. I guess what has Freddie Mac done to remedy this management deficiency?

Mr. BAUMANN. I have absolute responsibility for financial disclosures and all disclosures at Freddie Mac and my job is to ensure that all disclosures are complete, accurate, transparent, honest and reliable. As I said before, I have no responsibility to run the businesses and I have no responsibility for what the earnings are of the company. My job is to ensure that all of our disclosures are complete and unbiased and accurate.

Mr. STEARNS. In your opinion of 30 years with PriceWaterhouse and your job now as the CFO, should we encourage FASB to reform the use of mixed attribute accounting so that abuses like these described in the Doty report do not occur in the future? And if so, what would your recommendation be?

Mr. BAUMANN. A couple of comments to that. First of all, I agree with the comments that were made earlier that it isn't the accounting rules that caused the restatement, it was the fact that the company lacked expertise in implementing those rules. That was the real problem. Having said that I do agree with the initiatives, Congressman Stearns, that you are embarking upon to improve principles-based accounting, such that reports cannot be filed, but simply comply with rules, but at the same time, may not tell the whole story. Principles-based accounting and disclosures, in my mind, today even, disclosures in my mind, require companies to ensure that the entire story is told even if rules are complied with.

So further efforts on principles-based accounting to ensure that, I agree with.

In addition to that, movement toward fair value accounting so that there isn't a mixed model of some assets of fair value, some at cost, some liabilities at cost could create greater understanding of financial statements.

Mr. STEARNS. So you would not be using mixed attribute accounting in the future?

Mr. BAUMANN. Freddie Mac has to comply with GAAP and we will comply with GAAP and today's GAAP does have certain mixed attribute accounting requirements.

Mr. STEARNS. So you'll still use it?

Mr. BAUMANN. We have to use what the accounting rules are and fully disclose information. In addition to that, we've said we are supplementing that with further disclosures quarterly around fair values.

Mr. STEARNS. Will you also provide fair value accounts?

Mr. BAUMANN. We have said, first of all, GAAP requires that certain fair value information be provided annually. We have said that it is our intention, in addition, to provide fair value information and full fair value balance sheet on a quarterly basis going forward.

Mr. STEARNS. My time has expired.

Ms. SCHAKOWSKY. Thank you, Mr. Baumann, I appreciate the tough talk and I'm serious about that, that an acknowledgement of the problems that were and a commitment to make the changes. The one thing I noticed when you talked about what your responsibilities were for disclosure, you didn't mention timely.

And I'm concerned in your testimony when you said the objective of completing the process, that is voluntarily registering common stock with the SEC ASAP, as soon as possible, as opposed to exactly when? Now we know that—and you referred to—you affirmed the commitment that you had made, that had been made in July—you had made, yes, in July of 2003 in the restatement announcement and other public statements.

So when is this exactly going to happen? Fannie Mae, even with their accounting problems, already did it last March. I understand that it will be close to 2005 before you register.

Mr. BAUMANN. Congresswoman, if I omitted timely in my response to questions to Chairman Stearns, it was an error. My oral statement did say that I'm committed to developing an exemplary finance function that produces accurate, timely, well controlled and transparent financial reports.

First thing Freddie Mac had to do was to complete the restatement of prior years and as indicated in our restatement press release, the company made many accounting errors in the past. Correcting those errors means also correcting some financial infrastructure in the company to build accounting systems that are based on the right rules, not the wrong rules. We're doing that right now as quickly as possible. I've engaged all the major, really all the major consulting firms, are working with us in many ways to build that infrastructure as quickly as possible and as accurately and reliably as possible so we can get our financial statements, current, timely and continue with the 1934 Act registration process.

I've met with the Securities and Exchange Commission already and they have agreed that as soon as we get our 2002 annual report issued—

Ms. SCHAKOWSKY. Which is when?

Mr. BAUMANN. February, which will be in February, our 2002 annual report, that the SEC is willing to re-engage with us in discussing the registration process so we can begin a draft of the filing such that as soon as we become current in our financial reports, that we could be registered with the SEC as promptly as possible.

Ms. SCHAKOWSKY. And when is 2003 going to be done?

Mr. BAUMANN. We've stated that our objective is to release our 2003 results by June 30, 2004. And as I indicated, that's the function of building the accounting infrastructure that we need to ultimately get timely in the long term as well as getting the results out the door.

Ms. SCHAKOWSKY. Timely being 6 weeks after the quarter?

Mr. BAUMANN. Approximately and that's with the SEC guidelines, that's correct. That's approximately the timeframe.

Ms. SCHAKOWSKY. Well, if you were registered with the SEC, it would be approximately. That would be what it is.

Mr. BAUMANN. It's 45 days, the rules, and they are coming down to 35 days over the next year, that's correct.

Ms. SCHAKOWSKY. The legislation that would remove the exemption, does Freddie Mac have a position on that legislation?

Mr. BAUMANN. The 1933 Act legislation on the registration of securities is really designed to help consumers, more so than to help Freddie Mac. It's very important that consumers getting mortgages are able to look in an interest rate on their house. They're able to do that because of the way the mortgage market operates. Mortgage brokers are able to lock in interest rates for consumers because of the to be announced mortgage market that they can lock in the mortgage rates—

Ms. SCHAKOWSKY. So you support the legislation?

Mr. BAUMANN. It would not be good for consumers. It would increase the cost of mortgages to homeowners. So we do not support that.

Ms. SCHAKOWSKY. I would recommend that you rethink that position. I think that there are a lot of people out there that would feel a great deal more confidence if Freddie had to abide by the same rules as other corporations that already feel that how come there hasn't been this full disclosure, while it's voluntary. And I think that it would ultimately be in your interest to rethink your position on that legislation.

Let me just ask you—I'm out of time. Thank you, Mr. Chairman.

Mr. STEARNS. Thank you. The gentleman from New Jersey is recognized, Mr. Ferguson.

Mr. FERGUSON. Thank you, Mr. Chairman. I appreciate Mr. Baumann for being here today and certainly appreciate all the work that the new management team is going through. Obviously, there was a lot of bad thing going on at Freddie and I appreciate the tough talk. We appreciate the work that the new management team has been putting into place, obviously, very, very disconcerting the things that have come out, the things that we have learned and the things now that you're sharing with us and previous panel was sharing with us this morning.

I'm actually just interested, I have a couple of questions about the restatement and how it's affected the current status of the company and some of the financial aspects of the company. First, what is the effect that the restatement has on your current capital position at the company?

Mr. BAUMANN. The restatement increased the company's regulatory capital by \$5.2 billion, so the fact that the earnings were restated upwards strengthened the capital position in the company. The company is fully in compliance with our capital guidelines and has a very large and healthy capital surplus.

Mr. FERGUSON. So in addition to the fact that people should have more confidence in the management team because of what's been uncovered and the new commitments and the verbal commitments and other protections that you put in place with the new management team, in addition to perhaps confidence that people should

have in the new management team, there's also perhaps reason to have confidence in the new financial position of the company.

Mr. BAUMANN. Freddie Mac's financial position has been strong throughout this, before the restatement and after the restatement, Freddie Mac's financial condition is very strong, a strong capital position, as I stated in my testimony. The risks that we measure and monitor in our business, interest rate risk which is inherent in mortgages and credit risk that we guarantee is part of our business, are those risks that we maintain control of those risks. Our risk measures are low. Our business fundamentals are very sound.

Mr. FERGUSON. So things are actually going very, very well. The deceptions and what not of the prior management team, it wasn't as if you were doing really poorly and these—the misleading facts and reports and accounting practices and what not made the company look a little bit better. In fact, the company was doing quite well and things were made to look a little bit worse than they were because with the restatement you're position obviously is much stronger. Would you agree with that?

Mr. BAUMANN. The reported financial position is \$5 billion of capital greater than previously before the restatement, so the business fundamentals of Freddie Mac were sound before and continue to be sound, yes.

Mr. FERGUSON. Following the restatement, what do you owe the Federal Government in taxes?

Mr. BAUMANN. The additional taxes that were due to the Federal Government from the restatement were less than—under \$30 million. So the restatement had a pretax accounting impact of about \$7.5 billion, more or less. Then we provided income tax from a GAAP accounting perspective of about \$2.5 billion, but that's deferred taxes that's really not reportable for taxes in accordance with tax rules until and unless those amounts are realized. It's largely unrealized gains there. So the tax liability that additional tax liability that was owed was somewhere just slightly less than \$30 million.

Mr. FERGUSON. That's all I had for questions, I just wanted to wish you well. You've got a long road ahead of you in terms of regaining the trust and confidence of people in the financial community and the public and certainly taxpayers. It seems to be that you're on the right road and obviously the company's position is a strong one in terms of financial status, but in terms of rebuilding that confidence of your new management team, there's obviously a lot of work that still needs to be done. You seem to be done on the right track, so we certainly wish you well and we're going to continue to monitor, of course, your progress, and look forward to working with you in the future.

Thank you, Mr. Chairman.

Mr. BAUMANN. Thank you very much.

Mr. STEARNS. And I thank—I echo the encouragement of the gentleman from New Jersey.

Mr. Markey?

Mr. MARKEY. Thank you, Mr. Chairman. Mr. Baumann, for years, Freddie Mac has opposed the Shays-Markey bill to repeal your SEC registration and reporting exemption. In so doing, the company has argued that Freddie Mac's current disclosures already

meet or exceed the SEC's requirements and that Freddie Mac was at the vanguard of financial disclosure, accounting practices and risk management and that Freddie's disclosure "met or exceeded SEC requirements."

Based on what you now know about the accounting irregularities, disclosure inadequacies and the poor risk management at Freddie Mac, wouldn't you agree that those claims were simply not true?

Mr. BAUMANN. Freddie Mac has acknowledged that the public disclosures in the past were less than would have been required of an SEC registrant.

Mr. MARKEY. Has Freddie Mac reconsidered its previous opposition to repeal of your exemption from the full compliance with the SEC registration and reporting requirements? Are you now willing to support the Shays-Markey bill or some form of that that would require full disclosure?

Mr. BAUMANN. Congressman, Freddie Mac is committed to complete accurate, reliable, transparent, timely disclosures. We're going to lead the way in the future about the reliability and timeliness of disclosures. We're irrevocably committed to registering under the 1934 Act. With respect to the 1933 Act, as I commented earlier, we don't believe that's in the best interest of consumers. We think the impact of that would be an increase in mortgage costs and a lack of availability of locked in mortgage rates on 30 year mortgages.

Mr. MARKEY. You understand, Mr. Baumann——

Mr. BAUMANN. We don't think that's in the best interest——

Mr. MARKEY. You understand no one trusts Freddie Mac any more, no one trusts the numbers. They don't trust you saying that you're voluntarily going to do something. Voluntary commitments are like oral commitments. They aren't worth the paper that they aren't printed on.

And we don't trust you. We don't trust your organization. We need you to comply with the law, the same law that everyone else complies with. You're not going to have the trust of the American public, of the investing public, of the Congress, unless and until you fully comply with the same disclosure that other companies do.

There's no question that over the years that Freddie has been lying about its full compliance, has been lying about the fact that it's meeting the same standards as every other company in America.

So you're saying that we can't expect Freddie to have final registration statement filed with the SEC and declared effective, that you're not going to do that?

Mr. BAUMANN. Under the 1934 Act——

Mr. MARKEY. No, under the 1933 Act, you're not going to do it?

Mr. BAUMANN. The SEC has studied this. The Administration has studied this issue just last year and determined that it was their view that it was not necessary for the agencies to register under the 1933 Act and felt that 1934 Act registration was appropriate and we are committed to 1934 Act registration.

Mr. MARKEY. But you do realize that after that, a scandal broke out. They evaluated it. They said it wasn't needed and then one of the hugest scandals in financial history broke out then at your

company. You understand that? You may have made an evaluation, but it's obviously the same kind of erroneous evaluation that was made about weapons of mass destruction in Iran. It turned out that all of the intelligence and analysis up until the point at which that scandal occurred was inaccurate.

So I'm asking you again, knowing what you know how, after the scandal, do you believe that Freddie should have to comply with the 1933 Act requirements?

Mr. BAUMANN. Congressman, again, it's our position that registering under the 1934 Act will have all of the disclosure requirements about our financial condition, the same as any other company in America. However, the 1933 Act registration would not enhance that at all—

Mr. MARKEY. Fine.

Mr. BAUMANN. But would be a cost to consumers.

Mr. MARKEY. Several months ago, my staff and the subcommittee staff asked your staff to provide us with copies of the draft registration statement Freddie Mac filed with the Commission in November 2002, along with copies of any comments provided by the SEC staff on this draft registration statement and any related correspondence between Freddie Mac, its legal counsel and the SEC staff related to this draft registration statement.

Mr. Baumann, we haven't received any response to this request and so I would like to ask you if you are willing to commit to providing these documents to the subcommittee?

Mr. BAUMANN. As far as we know, we haven't gotten that request from the committee. We'd be happy to receive that request and do everything we can—

Mr. MARKEY. No, you received it. You received that request. You received that request.

Mr. BAUMANN. I'm told by our lawyers, we didn't receive it from the committee, but I'll look into that, Congressman.

Mr. MARKEY. So will we receive the information? I'm asking you now, will you send it to us? You have now received the request. Will you send it to us?

Mr. BAUMANN. We'll be happy to our lawyers meet with your lawyers to discuss that—

Mr. MARKEY. No, I'm asking you, Mr. Baumann. You're in charge. Will you give us the information? Not your lawyers talking to my lawyers. I'm talking to you. You're the boss.

Mr. BAUMANN. Right.

Mr. MARKEY. Do you want to give us the information or not? Or are you going to continue to play this hide and seek with us and the public?

Mr. BAUMANN. I will review that and I will get back to you.

Mr. MARKEY. Okay. Again, these voluntary commitments are like oral agreements. Again, they aren't worth the paper that they aren't printed on.

Freddie has been issuing press releases for years, claiming that it meets or exceeds SEC disclosure requirements and that Freddie is in the vanguard of corporate disclosure and we now know that those claims were simply not true. And investors in the financial markets just want you to simply give it up, comply with public disclosure requirements that every other public company also has to

comply with. And let me ask you one final question, if I may, and I appreciate your indulgence, Mr. Chairman.

In your response to Ms. Schakowsky, you said you oppose the Shays-Markey bill because of concerns over the impact that the bill would have on the to be issued market for your mortgage-backed securities.

Are you aware that the bill grants the SEC rulemaking authority so that it can adopt appropriately tailored rules to address this type of situation and in light of that authority, would you be willing to reconsider your opposition and support the bill? If that issue could be dealt with, would you then support the bill?

Mr. BAUMANN. There are many aspects of registration of the 1933 Act that are problematic, including not just the impact on the TBA market, which could impact the interest rate lock that consumers get. It could greatly increase our costs because of the volume of our security issuances which would have effect, therefore, in the long term of impacting the cost to consumers.

Also, it would have the significant impact on the Securities and Exchange Commission's ability to deal with the volume of securities that the two agencies issue.

A lot of these matters have been studied by the Administration and by the SEC and as a result of that, studies today indicate that that registration is not warranted.

Mr. MARKEY. Again, I think it's just a canard, once again, and I think it's an excuse not to comply. And I think that your maintenance here that the SEC is just stupid or incompetent and can't draft a regulation that would deal with your concerns is just further evidence that you just don't want to comply with the same regulations that every other company does. And your message to the investing public, to the millions of people who put their money in your company is just caveat emptor, it's 1898 at Freddie. And I just think again you're running an ahistorical company in terms of the transparency that should be provided to investors in ensuring that they get the information which they deserve.

Mr. Chairman, I have a UC request as well. I have three press releases issued by Freddie Mac, one dated October 19, 2000; one dated March 16, 2001; and one dated July 12, 2002, that all make claims that Freddie Mac is either in the vanguard of corporate disclosure and risk management or that Freddie Mac meets or exceeds SEC reporting standards and I would like to pass—

Mr. STEARNS. By unanimous consent, so ordered. What does 1898 mean to you?

Mr. MARKEY. That's before the Progressive movement began. That was before President McKinley passed away and Teddy Roosevelt took over.

Mr. STEARNS. Okay.

Mr. MARKEY. The Republican Party, by the way.

Mr. STEARNS. Right, that's what I was trying to lead to.

Mr. MARKEY. Thank you.

Mr. STEARNS. I was trying to bring out the Republican Party as being cited here.

The gentleman from Ohio.

Mr. STRICKLAND. Thank you, Mr. Chairman. Mr. Baumann, how long have you been CFO?

Mr. BAUMANN. I was hired by Freddie Mac as Executive Vice President of Finance in April 2003. I received the additional title of Chief Financial Officer in June of 2003.

Mr. STRICKLAND. So would you say you inherited a large headache, so to speak when you assumed these positions?

Mr. BAUMANN. I came into the company with a lot of work to be done in terms of improving the accounting expertise in the company, improving internal controls and getting the company registered under the 1934 Act. There's a lot of work to be done.

Mr. STRICKLAND. And is it your judgment that you made and are making progress?

Mr. BAUMANN. Yes. We are making significant progress. I've hired—since I've been here, over 100 people into our accounting functions to build the accounting expertise needed. We've issued, we've completed the restatement of prior years' results. We started to build the infrastructure up. We've greatly improved internal controls and as evidenced by the restatement press release, improved transparency around disclosures in terms of a description of those accounting errors that took place in the past, so we think we're well on our way to meeting the standards that should be expected of Freddie Mac which in my view are the highest standards that we should comply with.

Mr. STRICKLAND. I have one question. Over the last 3½ years, some of your biggest detractors, Freddie Mac's biggest detractors, I'm talking about GE, AIG, for example, have lost billions of dollars of shareholder money. GE has lost, I understand, about \$260 billion; AIG about \$70 billion. That's since the fall of 2000. These losses have hit the union pension funds particularly hard.

Even with the accounting problems that have existed at Freddie Mac, and the rather tough economic times that we've gone through, you haven't lost value over that same period of time. To what do you attribute Freddie's financial endurance during this period of time, especially when we consider the experience of some of your greatest critics?

Mr. BAUMANN. Well, first of all, understanding investors and the markets is a challenge for anybody to try to say why some companies increase in value and others don't increase or decrease in value, but that's always a challenge. But certainly Freddie Mac, throughout the restatement, the company has had very strong business fundamentals.

The company has fulfilled the mission of putting people in homes. The company has maintained very low interest rate risk measures. It's maintained very low credit risk measures. It's been very prudent in its acquisition of mortgages for the retained portfolio, acquiring mortgages as appropriate in terms of managing that risk and fulfilling its responsibilities.

So I suspect investors are looking at the Agency and saying that we are fulfilling our responsibilities, doing it in a prudent, measured way and the company is safe and sound.

Mr. STRICKLAND. I thank you for the answer. Thank you, Mr. Chairman.

Mr. STEARNS. Thank you. I think we are complete. Mr. Baumann, I just want to reiterate what you said in your opening statement is your mission is to supply low cost mortgage for Amer-



ican families wherever and whenever they need them. You're doing that job very well and I think Freddie Mac should be proud of that and as any corporation knows occasionally there's some people that do things that have to be corrected and we're doing that and I encourage you and I want to thank you for testifying and I think you provided enhanced credibility for your corporation by you being here and your forthright presentation and your character and personality I think comes through.

That's why you were hired to be the CFO, so I'm here to thank you and also say that I think overall we had a pretty good hearing, bringing out some of the problems. It doesn't hurt to bring these problems out. If the problems continue, that's a problem, but it looks like you're on top of them. You're trying to correct them and I think that's good for the investors and that's good for America.

So with that, the subcommittee is adjourned.

Mr. BAUMANN. Thank you, Mr. Chairman.

[Whereupon, at 11:51 a.m., the hearing was concluded.]

[Additional material submitted for the record follows:]

MICHAEL BLURAKIS, FLORIDA  
 JOE BARTON, TEXAS  
 FRED UPTON, MICHIGAN  
 CLIFF STEARNS, FLORIDA  
 PAUL E. GILMORE, OHIO  
 JAMES C. GREENWOOD, PENNSYLVANIA  
 CHRISTOPHER COX, CALIFORNIA  
 NATHAN DEAL, GEORGIA  
 RICHARD BURN, NORTH CAROLINA  
 ED WHITFIELD, KENTUCKY  
 CHARLIE NORWOOD, GEORGIA  
 BARBARA CUBIN, WYOMING  
 JOHN SHANKUS, ILLINOIS  
 HEATHER WILSON, NEW MEXICO  
 JOHN B. SHADEGG, ARIZONA  
 CHARLES W. "CHIP" PICKERING, MISSISSIPPI  
 VITO FOSSELLA, NEW YORK  
 ROY BLUNT, MISSOURI  
 STEVE BUYER, INDIANA  
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 CHARLES E. BASS, NEW HAMPSHIRE  
 JOSEPH R. PITTS, PENNSYLVANIA  
 MARY BONO, CALIFORNIA  
 GREG WALDERA, OREGON  
 LEE TERRY, NEBRASKA  
 ERNE FLETCHER, KENTUCKY  
 WYNE FERGUSON, NEW JERSEY  
 MIKE ROGERS, MICHIGAN  
 DARRIN L. RISA, CALIFORNIA  
 C. "BUTCH" OTTER, IDAHO

ONE HUNDRED EIGHTEEN CONGRESS  
**U.S. House of Representatives**  
**Committee on Energy and Commerce**  
**Washington, DC 20515-6115**

W.J. "BILLY" TAUZIN, LOUISIANA,  
 CHAIRMAN

January 28, 2004

JOHN D. DINGELL, MICHIGAN  
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DAN R. BROUILLETTE, STAFF DIRECTOR

Mr. Armando Falcon Jr.  
 Director  
 Office of Federal Housing Enterprise Oversight  
 1700 G Street, N.W., 4th Floor  
 Washington, D.C. 20552

Dear Mr. Falcon:

Thank you for your testimony at this morning's hearing entitled "Freddie Mac's Accounting Restatement: Are Accounting Standards Working?" We commend and appreciate your organization's ongoing efforts to improve regulatory oversight of the housing government-sponsored enterprises and to implement needed reforms at Freddie Mac. This Subcommittee's focus is what went wrong under applicable accounting standards, and we are appalled at the magnitude of the problems revealed in OFHEO's December 2003 Report of the Special Examination of Freddie Mac.

Your written testimony stated at page 9:


"The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, also contributed to the improper accounting and management practices of the Enterprise. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. While not tied directly to smoothing earnings growth, actions shifting earnings from one quarter to future periods helped ensure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future."

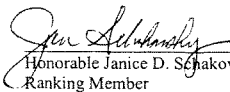
To assist the Subcommittee in its efforts to evaluate the scope and magnitude of this set of perverse incentives, we are following up on your commitment at today's hearing to submit for the hearing record a copy of OFHEO's recent report on executive compensation at Fannie Mae and Freddie Mac. We request a copy of the compensation of covered executives reviewed by OFHEO pursuant to OFHEO's statute. We ask that you provide us with this document by close of business on Monday, February 2, 2004. If you have any questions about this request, please contact David Cavicke, Senior Majority Counsel, at 225-2927, or Consuela Washington, Senior Minority Counsel, at 225-3641.

Mr. Armando Falcon  
Page 2

Thank you for your cooperation and attention to this matter.

Sincerely,

  
\_\_\_\_\_  
Honorable Cliff Stearns  
Chairman  
Subcommittee on Commerce, Trade,  
and Consumer Protection

  
\_\_\_\_\_  
Honorable Janice D. Schakowsky  
Ranking Member  
Subcommittee on Commerce, Trade,  
and Consumer Protection



*OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT*  
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800  
*Office of the Director*

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February 2, 2004

Honorable Cliff Stearns  
Chairman  
Subcommittee on Commerce, Trade,  
and Consumer Protection  
Committee on Energy and Commerce  
U.S. House of Representatives  
2125 Rayburn House Office Building  
Washington, DC 20515

Honorable Janice D. Schakowsky  
Ranking Member  
Subcommittee on Commerce, Trade,  
and Consumer Protection  
Committee on Energy and Commerce  
U.S. House of Representatives  
2322 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Stearns and Ranking Member Schakowsky:

Thank you again for the opportunity to testify on OFHEO's report of its special examination of Freddie Mac. As requested at the hearing and, more specifically, pursuant to your joint written request of January 28, 2004, enclosed is information pertaining to compensation at Fannie Mae and Freddie Mac. In particular, the enclosed information delineates executive compensation of "covered individuals" at Fannie Mae and Freddie Mac (the Enterprises), major components of Freddie Mac's employment agreement with Richard Syron, as well as information on severance, retirement, and other compensation for the executive officers at both Enterprises. Please note that this information is confidential and proprietary.

If you have any questions about these materials or matters related to your request, please do not hesitate to contact me.

Sincerely,

Armando Falcon, Jr.  
Director

Enclosures

W.J. "BILLY" TAUZEN, LOUISIANA  
RALPH M. HALL, TEXAS  
MICHAEL B. BRADY, FLORIDA  
FRED LUTON, MICHIGAN  
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C. "BUTCH" OTTER, IDAHO  
JOHN SULLIVAN, DELAWARE

BLUD ALBRIGHT, STAFF DIRECTOR

ONE HUNDRED EIGHTH CONGRESS

**U.S. House of Representatives**  
**Committee on Energy and Commerce**  
**Washington, DC 20515-6115**

JOE BARTON, TEXAS  
CHAIRMAN

May 13, 2004

JOHN D. DINGELL, MICHIGAN  
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JAN BERNARDINI, ALABAMA  
MELBA S. STUBBS, CALIFORNIA  
CHARLES A. STENBERG, TEXAS

Mr. Armando Falcon, Jr.  
Director  
Office of Federal Housing Enterprise Oversight  
1700 G Street NW, 4th Floor  
Washington, DC 20552

Dear Mr. Falcon:

We are writing with reference to your letter of February 2, 2004, and enclosures, which you submitted in response to our request for targeted executive-compensation information at Freddie Mac and Fannie Mae. Thank you for your cooperation with the work of the Subcommittee. Your transmittal letter notes that the enclosed information is "confidential and proprietary."

The focus of the Subcommittee's January 28, 2004 hearing was Freddie Mac's accounting restatement, and, with that context as a case study, whether the accounting standards developed by the Financial Accounting Standards Board are working, and if not, why not. In that regard, your written testimony stated: "The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, also contributed to the improper accounting and management practices of the Enterprise."

We have reviewed your submission and find that it is not directly responsive to the Subcommittee's inquiry or the above-quoted allegation, and we request your assistance in better focusing your response. For example, you provided compensation information for 20 names at Freddie Mac and 23 names at Fannie Mae. These individuals are not identified. Please provide titles and job descriptions for these individuals. Without that information, we are unable in all cases to ascertain who had/has responsibility for the relevant management and accounting practices.

Your testimony explained: "The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings for share targets. While not tied directly to smoothing earnings growth, actions shifting earnings from one quarter to future periods helped endure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future." For the individuals referenced in the preceding paragraph, you provided


Mr. Armando Falcon, Jr.  
Page 2

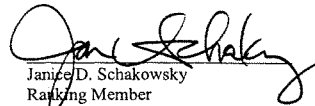
the Subcommittee with dollar amounts for nine compensation categories, including salary, bonus, and total compensation, without an explanation of the terms of the plans, where necessary, and identification of any compensation categories, other than the already noted bonus pool, that you believe posed or continue to pose an actual or potential conflict of interest. Also you only provided information for 2002 while the accounting problems at Freddie Mac spanned several years. We request that you provide the necessary explanation and analysis, and that you cover compensation for the years 2000, 2001, and 2002. This request extends to both Fannie Mae and Freddie Mac. We note that Fannie Mae has been an SEC-registered company for over a year, and, at this time, we are not aware of any problems with their disclosure or accounting practices. Nonetheless, we believe that it is appropriate and necessary to look at these issues as a prophylactic matter. Please also advise us of the status of OFHEO's review of Fannie's accounting practices, and whether, given Fannie's SEC-registered status, that review is being coordinated with the SEC.

We ask that you provide us with the requested information by the close of business on Friday, June 4, 2004. We would like to close the Subcommittee's hearing record and make decisions about the need for additional Congressional action as soon as reasonably possible. Pending receipt and review of the requested clarifications and additional information, we will respect the confidentiality of your original submission.

Thank you for your cooperation and attention to this matter.

Sincerely,

  
Cliff Stearns  
Chairman  
Subcommittee on Commerce, Trade,  
and Consumer Protection

  
Janice D. Schakowsky  
Ranking Member  
Subcommittee on Commerce, Trade,  
and Consumer Protection



**OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**  
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 Office of the Director

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June 4, 2004

Honorable Cliff Stearns  
 Chairman  
 Subcommittee on Commerce, Trade  
 and Consumer Protection  
 Committee on Energy and Commerce  
 U.S. House of Representatives  
 2125 Rayburn House Office Building  
 Washington, DC 20515

Honorable Janice D. Schakowsky  
 Ranking Member  
 Subcommittee on Commerce, Trade  
 and Consumer Protection  
 Committee on Energy and Commerce  
 U.S. House of Representatives  
 2322 Rayburn House Office Building  
 Washington, DC 20515

Dear Chairman Stearns and Ranking Member Schakowsky:

Thank you for the opportunity to expand upon the information I provided as follow-up to the Subcommittee's January 28, 2004 hearing on Freddie Mac's accounting restatement.

OFHEO's December 2003 Report of the Special Examination of Freddie Mac contained a detailed description of this Agency's investigation into whether executive compensation tied to Earnings Per Share contributed to the improper accounting and management practices at Freddie Mac. The examination concluded that it did. I believe that it may be most helpful if I summarize those findings now, as well as direct your attention to specific pages (60 – 66) of the report for additional detail and analysis. (Attachment A) I will also provide a description of Fannie Mae's Earnings Per Share Challenge Grants, a program that raises related questions about potential conflicts that arise when executive compensation is tied to a performance metric that may be improperly influenced by management actions.

We are gathering the additional compensation information that you requested for years prior to 2002, and I will provide this to you shortly. Attachment B provides the job titles and position descriptions to accompany the 2002 Freddie Mac compensation table in my letter of February 2, as well as additional information on categories that had not been clearly described. Attachment C provides equivalent information to accompany the Fannie Mae compensation table submitted February 2. Notably, the information contained in the Position Descriptions in Attachments B and C is confidential and proprietary.

**Report of the Special Examination of Freddie Mac**

At Freddie Mac, the direct compensation of executive officers includes three key components: base salary, an annual cash bonus, and long term stock incentives. As required by the Enterprise's charter, a significant portion of executive officers' compensation is based on the performance of the Enterprise.

During the period the exam focused on, 2000 – 2002, Freddie Mac established a "target bonus" incentive for each executive, at the beginning of each year. The sum of these target bonuses was known as the target "bonus pool." The overall funding of the bonus pool was determined by how well the Enterprise performed when assessed by metrics such as profitability and strategic positioning. The bonus plan

funding in 2000 was at 125 percent of the total target bonuses, and in 2001 was at 185 percent. For those years respectively, bonus payouts to the Chief Executive Officer (CEO) were \$1,700,000 and \$2,123,438. Bonus payouts in 2000 and 2001 to the Chief Operating Officer were \$1,009,000 and \$1,275,000, and to the Chief Financial Officer they were \$203,723 and \$333,000, respectively. After accounting errors were revealed, these individuals received no bonuses for 2002.

Earnings Per Share was a significant factor in the scoring process that determined an individual executive's bonus. For 2000, EPS as a share of the total score comprised 40 percent. For 2001, it comprised 63 percent. These bonuses provided a significant incentive to shift the timing of earnings recognition across years. Additional detail on this and related calculations are in the enclosed sections of OFHEO's Report of the Special Examination of Freddie Mac.

**Fannie Mae Earnings Per Share Challenge Grants**

In 1999, Fannie Mae management recommended that the Board of Directors (Board) approve a special stock option grant to provide an incentive for employees to double core business earnings per share (EPS) from 1998 to 2003. On January 23, 2004, the Board determined that Fannie Mae had doubled EPS within that time frame and the Challenge Grants vested, with a value of \$103,245,365 on that date. The expiration date to exercise the options is January 18, 2010.

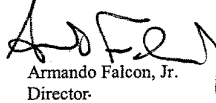
Senior executives received substantial value from the Challenge Grants. Fannie Mae states that the grant date present value of the options awarded to the Chairman and CEO is \$4,358,515. The value of Challenge Grant options awarded to three other senior officers exceeded \$1 million each.

Because these grants involved tying substantial amounts of executive compensation to a performance metric that may be directly influenced by management actions, OFHEO is reviewing them as part of our Fannie Mae review.

OFHEO's review of Fannie Mae's accounting began in February 2004 and is ongoing.

If you have any questions about these or related matters, please do not hesitate to contact me.

Sincerely,



Armando Falcon, Jr.  
Director

Enclosures